The Institute of Chartered Accountants in England and Wales

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Workbook

For exams in 2021

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Financial Management

The Institute of Chartered Accountants in England and Wales

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Contents

Questions within the Workbook should be treated as preparation questions, providing you with a firm foundation before you attempt the exam-standard questions. The exam-standard questions are found in the Question Bank.

Welcome to ICAEW

I'd like to personally welcome you to ICAEW.

In a fast-changing and volatile world, the role of the accountancy profession has never been more important.

As an ICAEW Chartered Accountant, you will make decisions that will define the future of global business.

By choosing our world-leading chartered accountancy qualification, the ACA, you will acquire exceptional knowledge and skills – with technology and ethics at the heart of your learning. A focus on capabilities such as judgement and scepticism will enable you to make the right decisions in diverse and often complex environments.

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I wish you the best of luck with your studies.

Michael Izza

Chief Executive

ICAEW

Financial Management

If you are studying this exam as part of the ACA qualification go to icaew.com/examresources or if you are studying the ICAEW CFAB qualification go to icaew.com/cfabstudents.

Module aim

Financial Management enables students to recommend relevant options for financing a business, recognise and manage financial risks and make appropriate investment decisions.

On completion of this module, students will be able to:

- identify capital requirements of businesses, assess financing options and recommend relevant methods of financing;
- identify the financial risks facing a business and the principal methods of managing those risks; and
- apply appropriate investment appraisal techniques taking into account other factors affecting investment decisions.

Method of assessment

The Financial Management module exam is 2.5 hours long. The exam consists of three questions. Managing financial risk will be assessed as a discrete topic. The other two questions will assess financing options and investment decisions and valuation either as discrete or integrated topics.

Specification grid

This grid shows the relative weightings of subjects within this module and should guide the relative study time spent on each. Over time the marks available in the assessment will equate to the weightings below, while slight variations may occur in individual assessments to enable suitably rigorous questions to be set.

	Weighting (%)
1 Financing options	35
2 Managing financial risk	30
3 Investment decisions and valuation	35

Permitted texts

At the Professional and Advanced Levels there are specific texts that you are permitted to use during your exam. All information for these texts is available on icaew.com/permittedtexts.

Professional level exams	Permitted text
Audit and Assurance	✔
Financial Accounting and Reporting	✔
Tax Compliance	✔
Business Strategy and Technology	x
Financial Management	x
Business Planning	No restrictions

Advanced Level exams	
Corporate Reporting	No restrictions
Strategic Business Management	No restrictions
Case Study	No restrictions

The exams which have no restrictions include the following:

- Business Planning: Banking;
- Business Planning: Insurance;
- Business Planning: Taxation;
- Corporate Reporting;
- Strategic Business Management; and
- Case Study.

This information, as well as what to expect and what is and is not permitted in each exam is available in the Instructions to Candidates. You will be sent the instructions with your exam admission details. They can also be viewed on our website at icaew.com/exams.

Key resources

Whether you're studying the ACA qualification with an employer, at university, independently (self-studying), or as part of an apprenticeship, we provide a wide range of resources and services to help you in your studies.

Take a look at the online exam resources available to you on icaew.com/examresources and discover more resources and services at icaew.com/studentbenefits.

Syllabus, skills development and technical knowledge grids

This syllabus presents the learning outcomes for each exam and should be read in conjunction with the relevant technical knowledge grids and, where applicable, the skills development grids.

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A variety of exam resources and support have been developed on each exam to help you on your journey to exam success. This includes exam guidance, sample exams, hints and tips from examiners and tutors, on-demand webinars and articles.

Past exams and mark plans

Use past exams to practise answering questions. The mark plans will help you check your answers. The past exams and mark plans are included in your Question Bank and have been updated to reflect the 2021 legislation and syllabus.

Errata sheets

These documents will correct any omissions within the learning materials once they have been published. You should refer to them when studying.

Exam software

It is vital that you are familiar with the exam software before you take your exam. Access a variety of resources, including the practice software and sample exams at icaew.com/studentresources.

Student support team

Our student support team is here to help and advise you, so do not hesitate to get in touch. Email studentsupport@icaew.com or call +44 (0)1908 248 250. If you are browsing our website, look out for the live help boxes. You will be able to speak directly to an adviser. Mia, our ChatBot, is also on hand to answer your queries.

Online student community

The online student community is the place where you can post your questions and share your study tips. Join the conversation at icaew.com/studentcommunity.

ICAEW Quarterly and Student Insights

As an ACA student, you will also receive a copy of our member magazine, *Quarterly*. Read more at icaew.com/insights.

You'll also be able to access our practical and topical student content on our dedicated online student hub, Student Insights.

You'll find new-look features, interviews and guides giving you fresh insights, innovative ideas and an inside look at the lives and careers of our ICAEW students and members. No matter what stage you're at in your journey with us, you'll find content to suit you.

Tuition

The ICAEW Partner in Learning scheme recognises tuition providers who comply with our core principles of quality course delivery. If you are not receiving structured tuition and are interested in doing so, take a look at ICAEW recognised Partner in Learning tuition providers in your area at icaew.com/dashboard.

CABA

It can be tough juggling your studies with work, planning for the future and finding time to unwind. CABA are an independent charity that supports the well-being of the chartered accountant community. So, if you need support at home or at work, CABA is there for you. They provide information, advice and lifelong support to ACA students across the world face-to-face, over the phone and online. All their services are completely free and strictly confidential. Find out more at caba.org.uk.

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Skills within the ACA

Professional skills are essential to accountancy and your development of them is embedded throughout the ACA qualification.

The level of competency required in each of the professional skills areas to pass each module exam increases as ACA trainees progress upwards through each Level of the ACA qualification. The skills progression embedded throughout the ACA qualification ensures ACA trainees develop the knowledge and professional skills necessary to successfully operate in the modern workplace and which are expected by today's forward-thinking employers.

The following professional skills areas are present throughout the ACA qualification.

Skill area	Overall objective
Assimilating and using information	Understand a business or accounting situation, prioritise by determining key drivers, issues and requirements and identify any relevant information.
Structuring problems and solutions	Structure information from various sources into suitable formats for analysis and provide creative and pragmatic solutions in a business environment.
Applying judgement	Apply professional scepticism and critical thinking to identify faults, gaps, inconsistencies and interactions from a range of relevant information sources and relate issues to a business environment.
Concluding, recommending and communicating	Apply technical knowledge, skills and experience to support reasoning and conclusion and formulate opinions, advice, plans, solutions, options and reservations based on valid evidence and communicate clearly in a manner suitable for the recipient.

The following provides further detail on the professional skills that you will develop in this particular module. To see the full skills development grids, please go to icaew.com/examresources.

Assimilating and using information

Understand the situation and the requirements

- Demonstrate understanding of the business context
- Recognise new and complex ideas within a scenario
- Identify the needs of customers and clients
- Explain different stakeholder perspectives and interests
- Identify risks within a scenario
- Identify elements of uncertainty within a scenario
- Identify ethical issues including public interest and sustainability issues within a scenario

Identify and use relevant information

- Interpret information provided in various formats
- Evaluate the relevance of information provided
- Use multiple information sources
- Filter information provided to identify critical facts

Identify and prioritise key issues and stay on task

- Identify business and financial issues from a scenario
- Prioritise key issues
- Work effectively within time constraints
- Operate to a brief in a given scenario

How skills are assessed: students may be required to:

- absorb and understand both structured and unstructured material; and

- give recommendations based on their understanding and interpretation of the information provided, supported by explanation of the reasoning behind and implications of their recommendations.

Structuring problems and solutions

Structure data

- Structure information from various sources into suitable formats for analysis
- Identify any information gaps
- Frame questions to clarify information
- Use a range of data types and sources to inform analysis and decision making
- Structure and analyse financial and non-financial data to enhance understanding of business issues and their underlying causes
- Present analysis in accordance with instructions and criteria

Develop solutions

- Identify and apply relevant technical knowledge and skills to analyse a specific problem
- Use structured information to identify evidence-based solutions
- Identify creative and pragmatic solutions in a business environment
- Identify opportunities to add value
- Identify and anticipate problems that may result from a decision
- Identify a range of possible solutions based on analysis
- Identify ethical dimensions of possible solutions
- Select appropriate courses of action using an ethical framework
- Identify the solution which is the best fit with acceptance criteria and objectives
- Define objectives and acceptance criteria for solutions

How skills are assessed: students may be required to:

- assimilate significant amounts of information, to analyse it (including quantitative analysis) in a way that demonstrates relevant technical knowledge and to draw and support appropriate conclusions.

Applying judgement

Apply professional scepticism and critical thinking

- Recognise bias and varying quality in data and evidence
- Identify assumptions or faults in arguments
- Identify gaps in evidence
- Identify inconsistencies and contradictory information
- Assess interaction of information from different sources
- Exercise ethical judgement

Relate issues to the environment

- Appreciate when more expert help is required
- Identify related issues in scenarios
- Assess different stakeholder perspectives when evaluating options
- Retain an overview of the business issue or scenario
- Appraise corporate responsibility and sustainability issues
- Appraise the effects of alternative future scenarios
- Appraise ethical, public interest and regulatory issues

How skills are assessed: students may be required to:

- make sense of relatively large volumes of data, making judgments on the relevance of data for use in subsequent calculations and discussions;
- reflect on their calculations and the methodology employed and to identify and discuss the implications of calculations; and

- make and justify judgements based on earlier calculations.

Concluding, recommending and communicating

Conclusions

- Apply technical knowledge to support reasoning and conclusions
- Apply professional experience and evidence to support reasoning
- Use valid and different technical skills to formulate opinions, advice, plans, solutions, options and reservations

Recommendations

- Present recommendations in accordance with instructions and defined criteria
- Make recommendations in situations where risks and uncertainty exist
- Formulate opinions, advice, recommendations, plans, solutions, options and reservations based on valid evidence
- Make evidence-based recommendations which can be justified by reference to supporting data and other information
- Develop recommendations which combine different technical skills in a practical situation

Communication

- Present a basic or routine memorandum or briefing note in writing in a clear and concise style
- Present analysis and recommendations in accordance with instructions
- Communicate clearly to a specialist or non-specialist audience in a manner suitable for the recipient
- Prepare the advice, report, or notes required in a clear and concise style

How skills are assessed: students may be required to:

- recommend suitable courses of action in a given situation (financing decisions, dividend decisions, investment appraisal decisions); and
- incorporate advice within a 'business report' format, addressing both the strengths and weaknesses of any recommendations and/or reasons for the rejection of alternatives.

To help you develop your ability to demonstrate competency in each professional skills area, each chapter of this Workbook includes up to four Professional Skills Guidance points.

Each Professional Skills Guidance point focuses on one of the four ACA Professional Skills areas and explains how to demonstrate a particular aspect of that professional skill relevant to the topic being studied. You are advised to refer back to the Professional Skills Guidance points while revisiting specific topics and during question practice.

Chapter 1

Income taxes

Introduction

Learning outcomes

- Explain, determine and calculate how current and deferred tax is recognised and appraise accounting standards that relate to current tax and deferred tax
- Determine for a particular scenario what comprises sufficient, appropriate audit evidence
- Design and determine audit procedures in a range of circumstances and scenarios, for example identifying an appropriate mix of tests of controls, analytical procedures and tests of details
- Demonstrate and explain, in the application of audit procedures, how relevant ISAs affect audit risk and the evaluation of audit evidence

Specific syllabus references for this chapter are: 8(a), 14(c), 14(d), 14(f)

1 Current tax revised

Section overview

Current tax is the amount payable to the tax authorities in relation to the trading activities of the current period.

2.1 Background

Accounting for current tax is ordinarily straightforward. Complexities arise, however, when we consider the future tax consequences of what is going on in the financial statements now. This is an aspect of tax called deferred tax, which has not been covered in earlier studies and which we will look at in the next section. IAS 12, *Income Taxes* covers both current and deferred tax. The parts of this study manual relating to current tax are fairly brief, as this has been covered at Professional Level.

2.2 Recognition of current tax liabilities and assets

Current tax is the amount payable to the tax authorities in relation to the current trading activities.

IAS 12 requires any **unpaid tax** in respect of the current or prior periods to be recognised as a **liability**. Conversely, any **excess tax** paid in respect of current or prior periods over what is due should be recognised as an asset to the extent it is probable that it will be recoverable.

The tax rate to be used in the calculation for determining a current tax asset or liability is the rate that is expected to apply when the asset is expected to be recovered, or the liability to be paid. These rates should be based on tax laws that have already been enacted (are already part of law) or substantively enacted (have already passed through sufficient parts of the legal process that they are virtually certain to be enacted) by the reporting date.

2.3 Measurement

Measurement of current tax liabilities (assets) for the current and prior periods is very simple. They are measured at the **amount expected to be paid to (recovered from) the tax authorities**. The tax rates (and tax laws) used should be those enacted (or substantively enacted) by the reporting date.

2.4 Recognition of current tax

Normally, current tax is recognised as income or expense and included in the net profit or loss for the period. However, where tax arises from a transaction or event which is recognised **as other comprehensive income** or recognised **directly in equity** (in the same or a different period) rather than in profit or loss, then the related tax should also be reported within other comprehensive income or reported directly in equity. An example of such a situation is where, under IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, an adjustment is made to the **opening balance of retained earnings** due to either a change in accounting policy that is applied retrospectively, or to the correction of a material error. Any related tax is therefore also recognised directly in equity.

2.5 Presentation

In the statement of financial position, **tax assets and liabilities** should be shown separately.

Current tax assets and liabilities may only be **offset** under the following conditions.

- The entity has a **legally enforceable right** to set off the recognised amounts.
- The entity intends to settle the amounts on a **net basis**, or to realise the asset and settle the liability at the same time.

The **tax expense (income)** related to the profit or loss from ordinary activities should be shown on the face of the statement of profit or loss and other comprehensive income as part of profit or loss for the period. The **disclosure requirements** of IAS 12 are extensive and we will look at these later in the chapter.

3 Deferred tax – an overview

Section overview

- Deferred tax is an accounting measure used to match the tax effects of transactions with their accounting impact and thereby produce less distorted results. It is not a tax levied by the Government that needs to be paid.
- You have studied current tax at Professional Level, but deferred tax is new to Advanced Level, so you should focus on deferred tax.
- **Note that UK tax is not specifically examinable, but examples from UK tax are sometimes used in this chapter for illustrative purposes.**
- **The rules to determine the tax base in the jurisdiction in the question, will be given to you in the exam.**

4.1 What is deferred tax?

When a company recognises an asset or liability, it expects to **recover or settle the carrying amount** of that asset or liability. In other words, it expects to sell or use up assets, and to pay off liabilities. What happens if that recovery or settlement is likely to make future tax payments larger (or smaller) than they would otherwise have been if the recovery or settlement had no tax consequences? In these circumstances, IAS 12 requires companies to recognise a **deferred tax liability** (or **deferred tax asset**).

Tutorial note

Deferred tax is not a tax that the entity pays. It is an **accounting measure**, used to match the tax effect of transactions with their accounting effect.

4.2 Accounting profits vs taxable profits

Although **accounting profits** form the basis for computing **taxable profits**, on which the tax liability for the year is calculated, **accounting profits** and **taxable profits** are often different for two main reasons:

(a) Permanent differences

(b) Temporary differences

4.2.1 Permanent differences

These arise when items of revenue or expense included in the accounting profit are excluded from the computation of taxable profits. For example:

- Client entertaining expenses are not tax allowable in the UK.
- UK companies are not taxed on dividends from other UK companies and overseas companies.

Note that IAS 12 does not refer to the term 'permanent differences'; this is a UK GAAP term.

4.2.2 Temporary differences

These arise when items of revenue or expense are included in both accounting profits and taxable profits, but not in the same accounting period. For example, both depreciation and capital allowances write off the cost of a non-current asset, though not necessarily at the same rate and over the same period.

Context example: Context example: Temporary differences 1

A company buys an item of machinery on the first day of the financial year, 1 January 20X0, at a cost of £100,000 and applies straight-line depreciation at a rate of 10%. Capital allowances are available at 20% reducing balance.

y/e 31 December	Depreciation (10% SL)	Capital allowances (20% RB)
20X0	£10,000	£20,000
20X1	£10,000	£16,000
20X2	£10,000	£12,800
20X3	£10,000	£10,240 and so on

Therefore in 20X0, accounting profits are reduced by £10,000 but taxable profits are reduced by £20,000, so providing one reason why the tax charge is not equal to the tax rate multiplied by the accounting profit.

At this point it could be said that the temporary difference is equal to the £10,000 difference between depreciation and capital allowances.

In the long run, the total taxable profits and total accounting profits will be the same (except for permanent differences). In other words, temporary differences which originate in one period will reverse in one or more subsequent periods.

Deferred tax is an accounting adjustment to smooth out the discrepancies between accounting profit and the tax charge caused by **temporary differences.**

4.3 Calculating and accounting for deferred tax

In order to calculate deferred tax, the following steps must be taken:

(a) Identify temporary differences

(b) Apply the tax rate to the temporary differences to calculate the deferred tax asset or liability

(c) Recognise the resulting deferred tax amount in the financial statements

Identification of temporary differences

Above we have considered temporary differences as being the result of income or expenditure being recognised in accounting and taxable profit in different periods.

IAS 12, however, requires that a 'net assets approach' rather than an 'income statement approach' is taken to calculate temporary differences.

Applying this approach to the illustration seen above, we would simply compare the carrying amount and the tax written-down value rather than depreciation and capital allowances in order to calculate the temporary difference:

	£
Carrying amount (£100,000 – £10,000)	90,000
Tax written-down value (£100,000 – £20,000)	80,000
Temporary difference	10,000

The identification of temporary differences is covered in more detail in section 3.

Apply the tax rate to temporary differences to calculate deferred tax asset or liability

The tax rate to be used is not necessarily the current tax rate. It should be the rate which is expected to apply to the period when the asset is realised or liability settled.

This is covered in more detail in section 4.

Record deferred tax in the financial statements

Depending on the circumstances, a deferred tax asset or liability may arise in the statement of financial position. The corresponding entry is normally recorded in:

- the tax charge in profit or loss; or
- other comprehensive income.

This is covered in more detail in section 5.

5 Identification of temporary differences

Section overview

Temporary differences are calculated as the difference between the carrying amount of an asset or liability and its tax base. Temporary differences may be classified as:

- taxable
- deductible

6.1 Calculation of temporary differences

Temporary differences are calculated as the difference between:

- the **carrying amount** of the asset or liability in the statement of financial position; and
- the '**tax base**' of the asset or liability.

6.1.1 Tax base

Definition

Tax base: The amount attributed to an asset or liability for tax purposes.

Assets

The tax base of an asset is the value of the asset in the current period for tax purposes. This is either:

- the amount that will be tax deductible in the future against taxable economic benefits when the carrying amount of the asset is recovered; or
- if those economic benefits are not taxable, the tax base is equal to the carrying amount of the asset.

Liabilities

- The tax base of a liability is its carrying amount less any amount that will be tax deductible in the future.
- For revenue received in advance, the tax base of the resulting liability is its carrying amount less any amount of the revenue that will **not** be taxable in future periods.

IAS 12 guidance

IAS 12 states that in the following circumstances, the tax base of an asset or liability will be equal to its carrying amount:

- **Accrued expenses** that have already been deducted in determining an entity's tax liability for the current or earlier periods
- A **loan payable** that is measured at the amount originally received and this amount is the same as the amount repayable on final maturity of the loan
- **Accrued income** that will never be taxable

The table below gives some examples of tax rules and the resulting tax base.

Item	Carrying amount in the statement of financial position	Tax rule	Tax base (amount in 'tax accounts')
Item of property, plant and equipment	**Carrying amount** = cost – accumulated depreciation	Attracts tax relief in the form of tax depreciation	**Tax written down value** = cost – accumulated tax depreciation
Accrued income	Included in financial statements on an accruals basis ie, when **receivable**	Chargeable for tax on a cash basis, ie when **received** Chargeable for tax on an accruals basis, ie, when **receivable**	Nil Same as carrying amount in statement of financial position
Accrued expenses and provisions	Included in financial statements on an accruals basis ie, when **payable**	Attracts tax relief on a cash basis, ie when **paid** Attracts tax relief on an accruals basis, ie, when **payable**	Nil Same as carrying amount in statement of financial position
Income received in advance	When the cash is received, it will be included in the financial statements as deferred income ie, a liability	Chargeable for tax on a cash basis, ie, when **received**	Nil

Context example: Context example: Tax base 1

Current liabilities include accrued fines and penalties with a carrying amount of £100. These fines and penalties are not deductible for tax purposes.

The tax base of the accrued fines and penalties is £100 (ie, equal to the carrying amount because the amount which will be deducted for tax purposes in a future period is nil).

As the tax base equals the statement of financial position carrying amount, there is no temporary difference and no deferred tax implications.

Context example: Context example: Tax base 2 XE "Tax base"

Scenario 1 – An entity's current assets include insurance premiums paid in advance of £20,000, for which a tax deduction will be allowed in future periods.

The tax base of the insurance premiums is £20,000, because the whole carrying amount will be deductible for tax purposes in future periods.

Scenario 2 – An entity has recognised a current liability of £400,000 in respect of income received in advance, which will be taxed in future periods.

The tax base of the liability is its £400,000 carrying amount.

Scenario 3 – An entity has recognised a defined benefit liability of £500,000 in respect of a defined benefit retirement plan, but no tax deduction is allowed until contributions are paid into the plan.

The tax base of the liability is nil, because the whole carrying amount will be deductible for tax purposes in future periods.

Scenario 4 – Two years ago, an entity recognised a non-current asset at its £1 million cost. Tax depreciation is allowed on the full cost at 15% per annum on a straight-line basis.

The tax base of the non-current asset is £700,000. 15% of cost has been allowed for tax purposes in each of the two years; the tax base is therefore the 70% of cost which will be deductible for tax purposes in future periods.

Interactive question 1: Tax base

State the tax base of each of the following items.

Requirements

1.1 Current liabilities include accrued expenses with a carrying amount of £1,000. The related expense will be deducted for tax purposes on a cash basis.

1.2 Current liabilities include interest revenue received in advance, with a carrying amount of £10,000. The related interest revenue was taxed on a cash basis.

1.3 Current assets include prepaid expenses with a carrying amount of £2,000. The related expense has already been deducted for tax purposes.

1.4 A loan payable has a carrying amount of £1 million. The repayment of the loan will have no tax consequences.

See **Answer** at the end of this chapter.

See **Answer** at the end of this chapter.

6.2 Types of temporary difference

IAS 12 makes a distinction between two types of temporary difference:

(a) Taxable temporary differences

(b) Deductible temporary differences

6.2.1 Taxable temporary differences

- Taxable temporary differences arise where the carrying amount exceeds the tax base.
- They result in a deferred tax liability.

Definitions

Taxable temporary differences: : Temporary differences that will result in taxable amounts in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.

Deferred tax liabilities:: The amounts of income taxes payable in future periods in respect of taxable temporary differences.

Context example: Context example: Temporary differences 2

Scenario 1 – An entity recognised a non-current asset at its £1 million cost two years ago. Tax depreciation is allowed on the full cost at 15% per annum straight line, while accounting depreciation is at 10% per annum straight line.

The tax base of the non-current asset is £700,000, but the carrying amount is £800,000. The taxable temporary difference is therefore the difference of £100,000.

Scenario 2 – An entity has issued £400,000 of debt redeemable in five years, incurring £20,000 of issue expenses. The issue expenses have been deducted from the liability and are being amortised over the five-year life of the debt. To date, £5,000 has been amortised, but the whole £20,000 has been allowed as a tax deduction.

The tax base of the liability is its £400,000 carrying amount less the £nil amount which is deductible for tax purposes in future periods. The carrying amount is £385,000 and the taxable temporary difference is therefore the difference of £15,000.

6.2.2 Deductible temporary differences

- Deductible temporary differences arise where the tax base exceeds the carrying amount.
- These result in a deferred tax asset.

Definitions

Deductible temporary differences: : Temporary differences that will result in amounts that are deductible in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.

Deferred tax assets: : The amounts of income taxes recoverable in future periods in respect of:

- deductible temporary differences; and
- the carry forward of unused tax losses/unused tax credits.

Context example: Context example: Temporary differences 3

A factory was purchased for £4 million and has been given cumulative capital allowances of £1 million. It therefore has a tax base of £3 million.

Assumption 1	If the carrying amount of the factory in the statement of financial position is £3.5 million, then there is a taxable temporary difference of £500,000. (**Note:** Where capital allowances claimed are cumulatively greater than accounting depreciation, this is sometimes referred to as 'accelerated' as the tax allowances have been awarded sooner than accounting depreciation has been recognised.)
Assumption 2	If, instead, the carrying amount of the factory in the statement of financial position is £2 million, then there is a deductible temporary difference of £1 million.

6.2.3 Summary diagram

The following diagram may help you remember the distinction:

IMAGE GOES HERE

Figure 22.1: Temporary differences

6.3 Temporary differences with no deferred tax impact

A deferred tax liability or asset should be recognised for all taxable and deductible temporary differences unless they arise from:

- the initial recognition of goodwill; or
- the initial recognition of an asset or liability in a transaction which:
  - is not a business combination; and
  - at the time of the transaction, affects neither accounting nor taxable profit.

Examples of initial recognition of assets or liabilities with no deferred tax effect

Examples of initial recognition of assets or liabilities in a transaction which does not affect either accounting or taxable profit at the time of the transaction are:

(a) An intangible asset with a finite life which attracts no tax allowances. In this case, taxable profit is never affected, and amortisation is only charged to accounting profit after the transaction.

(b) A non-taxable government grant related to an asset which is deducted in arriving at the carrying amount of the asset. For tax purposes it is not deducted from the tax base.

Although a deductible temporary difference arises in both cases (on initial recognition in the second case, and subsequently in the first case), this is not permitted to be recognised as a deferred tax asset, as it would make the financial statements less transparent. The first of the two cases, an intangible asset with a finite life which attracts no tax allowances, only gives rise to a deferred tax asset if it has a chargeable gains cost, that is, if it was acquired separately after April 2002. If it was acquired on consolidation, no deferred tax asset arises as the amortisation of the intangible just decreases consolidated retained earnings.

Worked example: Initial recognition

As another example of the principles behind initial recognition, suppose Petros Co intends to use an asset which cost £10,000 in 20X7 throughout its useful life of five years. Its residual value would then be nil. The tax rate is 40%. Any capital gain on disposal would not be taxable (and any capital loss not deductible). Depreciation of the asset is not deductible for tax purposes.

Requirement

State the deferred tax consequences in each of the years 20X7 and 20X8.

Solution

20X7

To recover the carrying amount of the asset, Petros will earn taxable income of £10,000 and pay tax of £4,000. The resulting deferred tax liability of £4,000 would not be recognised because it results from the initial recognition of the asset.

20X8

The carrying value of the asset is now £8,000. In earning taxable income of £8,000, Petros will pay tax of £3,200. Again, the resulting deferred tax liability of £3,200 is not recognised, because it results from the initial recognition of the asset.

6.4 Summary

The following diagram summarises the calculation and types of temporary difference:

IMAGE GOES HERE

Figure 22.2: The calculation and types of temporary difference

Context example: Context example: Tax base of assets

(a) A machine cost £100,000. For tax purposes, capital allowances of £30,000 have already been deducted in the current and prior periods; and the remaining cost will be deductible in future periods. Assume that revenue generated by using the machine is taxable, any gain on disposal of the machine will be taxable and any loss on disposal will be deductible for tax purposes. The carrying amount of the machine for accounting purposes is £82,000.

The tax base of the machine is £70,000 as this remains to be deducted in future periods. There is a taxable temporary difference of £12,000 (ie, £82,000 – £70,000).

(b) Interest receivable has a carrying amount of £1,000. The related interest revenue will be taxed on a cash basis.

The tax base of the interest receivable is nil, as the accrual is not recognised for tax purposes. There is therefore a taxable temporary difference of £1,000.

(c) Trade receivables have a carrying amount of £10,000. Assume that the related revenue has already been included in taxable profit.

The tax base of the trade receivables is £10,000. (**Note:** The difference between this case and the previous example is that in this case the amount has been included in both the accounting profit and the taxable profit for the period, thus there is no future taxable impact.) As the tax base equals the carrying amount, there is no temporary difference and no deferred tax.

(d) A loan receivable has a carrying amount of £8,000. The repayment of the loan will have no tax consequences.

The tax base of the loan is £8,000, as there are no future tax consequences. Thus, as the tax base equals the carrying value, there is no temporary difference and no deferred tax.

Worked example: Tax base of liabilities

In the following cases show and explain:

(1) the tax base

(2) temporary differences:

Requirements

1 Current liabilities include accrued expenses with a carrying amount of £2,000. The related expense will be deducted for tax purposes on a cash basis.

2 Current liabilities include accrued expenses with a carrying amount of £3,000. The related expense has already been deducted for tax purposes.

3 A loan payable has a carrying amount of £5,000. The repayment of the loan will have no tax consequences.

4 Current liabilities include interest revenue received in advance, with a carrying amount of £7,000. The related interest revenue was taxed on a cash basis.

Solution

1 The tax base of the accrued expenses is nil. This is because the expenses have been recognised in accounting profit, but the tax impact is yet to take effect. There is therefore a deductible temporary difference of £2,000.

2 The tax base of the accrued expenses is £3,000, ie, the carrying value (£3,000) less the amount which will be deducted for tax purposes in future periods (nil, as relief has already been obtained). There is no temporary difference, and no deferred tax arises.

3 The tax base of the loan is £5,000, as there are no future tax consequences. Thus, as the tax base equals the carrying value, there is no temporary difference and no deferred tax.

4 The tax base of the interest received in advance is nil (ie, the carrying value (£7,000) less the amount which will not be taxable in future periods (£7,000, as it has all been charged already). As a result there is a deductible temporary difference of £7,000.

---

7 Measurement of deferred tax assets and liabilities

8

The tax rate is applied to temporary differences in order to calculate the deferred tax asset or liability.

Section overview

The tax rate should be applied to temporary differences in order to calculate deferred tax:

- Taxable temporary differences × tax rate = deferred tax liability
- Deductible temporary differences × tax rate = deferred tax asset

Worked example: Calculation of deferred tax

A company purchased an asset costing £1,500. At the end of 20X8 the carrying amount is £1,000. The cumulative capital allowances are £900 and the current tax rate is 25%.

Requirement

Calculate the deferred tax liability for the asset.

Solution

The tax base of the asset is £1,500 – £900 = £600.

The carrying amount exceeds the tax base and therefore there is a taxable temporary difference of £1,000 – £600 = £400. The entity must therefore recognise a deferred tax liability of £400 × 25% = £100.

(In order to recover the carrying amount of £1,000, the entity must earn taxable income of £1,000, but it will only be able to deduct £600 as a taxable expense. The entity must therefore pay income tax of £400 × 25% = £100 when the carrying amount of the asset is recovered.)

8.1 Tax rate

The tax rates that should be used to calculate deferred tax are the ones that are expected to apply in the period when the asset is realised or the liability settled. The best estimate of this tax rate is the rate which has been enacted or substantively enacted by the reporting date.

For example, in the Summer Budget of 2015, the government announced legislation setting the Corporation Tax main rate (for all profits except ring fence profits) at 19% for the years starting on 1 April 2017, 2018 and 2019 and at 18% for the year starting 1 April 2020. Note that UK tax is not examinable; it is mentioned for illustrative purposes only.

The Accounting Standards Board (ASB) has stated that substantive enactment occurs when any future steps in the enactment process will not change the outcome. Specifically, in relation to the UK, the ASB has stated that this occurs when the House of Commons passes a resolution under the Provisional Collection of Taxes Act 1968.

Note: The tax rates used in this chapter are assumptions or hypothetical rates rather than real rates.

Worked example: Tax rate

A Muldovian company enters into a long-term contract to build a motorway in that country. During the year ended 31 December 20X3, the entity recognises £4 million of income on this contract even though it is not expected to receive the related cash until the year ending 31 December 20X5.

Under the tax rules of Muldovia, companies are charged tax on a cash receipts basis.

The tax rate for companies in Muldovia was 30% in the year to 31 December 20X3, but their Government has voted in favour of a reduction to 29% in 20X4. There is currently discussion of the rate dropping to 28% in 20X5, but as yet there is no agreement.

Requirement

What rate of tax should be used to determine the deferred tax balance?

Solution

A rate of 29% should be used. The rate is that expected to apply when the asset is realised, thus the rate of 30% in 20X3, when the temporary difference originated, is not relevant. The 28% would be used if it had been enacted or substantively enacted, but it is only under discussion. Thus, our best estimate of the rate applying in 20X5, based on laws already enacted or substantively enacted, is the rate for 20X4 (ie, the previous year) of 29%.

8.1.1 Progressive rates of tax

In some countries, different tax rates apply to different levels of taxable income. In this case, an **average rate** expected to apply to the taxable profit of the entity in the period in which the temporary difference is expected to reverse should be identified and used to calculate the temporary difference.

8.1.2 Different rates of tax

Some countries also apply different rates of tax to different types of income eg, one rate to profits and another to gains.

Where this is the case, the tax rate used to calculate the deferred tax amount should reflect the manner in which the entity expects to recover the carrying amount of assets or settle the carrying amount of liabilities.

Worked example: Manner of recovery/settlement

1 Richcard Co has an asset with a carrying amount of £10,000 and a tax base of £6,000. If the asset were sold, a tax rate of 20% would apply. A tax rate of 30% would apply to other income.

State the deferred tax consequences making the following alternative assumptions:

Requirements

The entity sells the asset without further use

2 The entity expects to retain the asset and recover its carrying amount through use

Solution

1 A deferred tax liability is recognised of £(10,000 – 6,000) ### SYMBOL GOES HERE ### 20% = £800.

2 A deferred tax liability is recognised of £(10,000 – 6,000) ### SYMBOL GOES HERE ### 30% = £1,200.

Interactive question 2: Recovery 1

Emida Co has an asset which cost £100,000. In 20X9 the carrying amount was £80,000 and the asset was revalued to £150,000. No equivalent adjustment was made for tax purposes. Cumulative depreciation for tax purposes is £30,000 and the tax rate is 30%. If the asset is sold for more than cost, the cumulative tax depreciation of £30,000 will be included in taxable income but sale proceeds in excess of cost will not be taxable.

Requirements

2.1 The entity expects to recover the carrying amount through continued use of the asset.

2.2 The entity expects to recover the carrying amount of the asset through sale.

See **Answer** at the end of this chapter.

The manner of recovery may also affect the tax base of an asset or liability. Tax base should be measured according to the expected manner of recovery or settlement.

Interactive question 3: Recovery 2

The facts are as in Recovery 1 above except that, if the asset is sold for more than cost, the cumulative tax depreciation will be included in taxable income (taxed at 30%) and the sale proceeds will be taxed at 40% after deducting an inflation-adjusted cost of £110,000.

Requirements

3.1 The entity expects to recover the carrying amount through continued use of the asset.

3.2 The entity expects to recover the carrying amount of the asset through sale.

See **Answer** at the end of this chapter.

8.2 Discounting

IAS 12 states that deferred tax assets and liabilities **should not be discounted** because the complexities and difficulties involved will affect reliability. Discounting would require detailed scheduling of the timing of the reversal of each temporary difference, but this is often impracticable. If discounting were permitted, this would affect comparability.

Note, however, that where carrying amounts of assets or liabilities are discounted (eg, a pension obligation), the temporary difference is determined based on a discounted value.

9 Recognition of deferred tax in the financial statements

Section overview

The deferred tax amount calculated is recorded as a deferred tax balance in the statement of financial position with a corresponding entry to the tax charge, other comprehensive income or goodwill.

10.1 Principles of recognition

As with current tax, deferred tax should normally be recognised as income or an expense amount within the tax charge, and included in the net profit or loss for the period. Only the movement in the deferred tax asset / liability on the statement of financial position is recorded:

DEBIT	Tax charge	X	
CREDIT	Deferred tax liability		X

or

DEBIT	Deferred tax asset	X	
CREDIT	ax charge		X

Note that the recognition of a deferred tax asset may be restricted (see section 5.2).

Worked example: Deferred tax in the financial statements

An entity purchases a machine for £64,000 at the beginning of the year to 31 December 20X1. It has a useful life of five years, and on 31 December 20X5 the asset is disposed of at a zero residual value. The entity uses straight-line depreciation. The accounting year end is 31 December.

Assume that the machine qualifies for capital allowances, at a rate of 20% per annum on a reducing balance basis.

Assume that the rate of tax is 30%.

Requirement

Show the deferred tax balance in the statement of financial position and the deferred tax charge for each year of the asset's life.

Solution

	20X1	20X2	20X3	20X4	20X5
	£	£	£	£	£
Carrying amount	51,200	38,400	25,600	12,800	0
Tax base	51,200	40,960	32,768	26,214	0
Taxable/(deductible) temporary difference	0	(2,560)	(7,168)	(13,414)	0
Opening deferred tax liability/(asset)	0	0	(768)	(2,150)	(4,024)
Deferred tax expense/(credit)	0	(768)	(1,382)	(1,874)	4,024
Closing deferred tax liability/(asset)	0	(768)	(2,150)	(4,024)	0

10.1.1 Exceptions to recognition in profit or loss

(a) Deferred tax relating to items dealt with as **other comprehensive income** (such as a revaluation) should be recognised as tax relating to other comprehensive income within the statement of profit or loss and other comprehensive income.

(b) Deferred tax relating to items dealt with **directly in equity** (such as the correction of an error or retrospective application of a change in accounting policy) should also be recognised directly in equity.

(c) Deferred tax resulting from a business combination is included in the initial cost of **goodwill** (this is covered in more detail later in the chapter).

Where it is not possible to determine the amount of current/deferred tax that relates to other comprehensive income and items credited/charged to equity, such tax amounts should be based on a reasonable **pro-rata allocation** of the entity's current/deferred tax.

10.1.2 Components of deferred tax

Deferred tax charges will consist of **two components**:

(a) Deferred tax relating to **temporary differences**

(b) Adjustments relating to **changes in the carrying amount of deferred tax assets/liabilities** (where there is no change in temporary differences) eg, changes in tax rates/laws, reassessment of the recoverability of deferred tax assets, or a change in the expected recovery of an asset

10.2 Deferred tax assets

A deferred tax asset must satisfy the recognition criteria given in IAS 12. These state that a deferred tax asset should only be recognised to the extent that it is probable that taxable profit will be available against which it can be used.

This is an application of prudence.

Worked example: Recognition of deferred tax asset

Pargatha Co recognises a liability of £10,000 for accrued product warranty costs on 31 December 20X7. Assume that these product warranty costs will not be deductible for tax purposes until the entity pays claims. The tax rate is 25%.

Requirement

State the deferred tax implications of this situation.

Solution

The carrying amount of the liability is (£10,000).

The tax base of the liability is nil (carrying amount of £10,000 less the amount that will be deductible for tax purposes in respect of the liability in future periods).

When the liability is settled for its carrying amount, the entity's future taxable profit will be reduced by £10,000 and so its future tax payments by £10,000 × 25% = £2,500.

The carrying amount of (£10,000) is less than the tax base of nil and therefore the difference of £10,000 is a deductible temporary difference.

The entity should therefore recognise a deferred tax asset of £10,000 × 25% = £2,500 provided that it is probable that the entity will earn sufficient taxable profits in future periods to benefit from a reduction in tax payments.

10.2.1 Future taxable profits

When can we be sure that sufficient taxable profit will be available, against which a deductible temporary difference can be used?

IAS 12 states that this is assumed when:

- there are sufficient taxable temporary differences;
- the taxable and deductible temporary differences relate to the same entity and same tax authority;
- the taxable temporary differences are expected to reverse either:
  - in the same period as the deductible temporary differences; or
  - in periods in which a tax loss arising from the deferred tax asset can be used.

Insufficient taxable temporary differences

Where there are insufficient taxable temporary differences, a deferred tax asset may only be recognised to the extent that:

(a) it is probable that taxable profits will be sufficient in the same period as the reversal of the deductible temporary difference (ignoring taxable amounts arising from future deductible temporary differences); and

(b) tax planning opportunities exist that will allow the entity to create taxable profit in the appropriate periods.

If an entity has a history of recent losses, then this is evidence that future taxable profit may not be available.

10.2.2 Reassessment of unrecognised deferred tax assets

For all unrecognised deferred tax assets, at each reporting date an entity should reassess the availability of future taxable profits and whether part or all of any unrecognised deferred tax assets should now be recognised. This may be due to an improvement in trading conditions which is expected to continue.

11 Common scenarios

Section overview

There are a number of common examples which result in a taxable or deductible temporary difference. However, this list is not exhaustive.

12.1 Taxable temporary differences

12.1.1 Accelerated capital allowances

- These arise when capital allowances for tax purposes are received before deductions for accounting depreciation are recognised in the statement of financial position (accelerated capital allowances).
- The temporary difference is the difference between the carrying amount of the asset at the reporting date and its tax written-down value (tax base).
- The resulting deferred tax is recognised in profit or loss.

Interactive question 4: Initial recognition

Jonquil Co buys equipment for £50,000 at the start of 20X1 and depreciates it on a straight-line basis over its expected useful life of five years. For tax purposes, the equipment is depreciated at 25% per annum on a straight-line basis. Tax losses may be carried back against the taxable profit of the previous five years. In 20X0, the entity's taxable profit was £25,000. The tax rate is 40%.

Requirement

Assuming nil profits/losses after depreciation in years 20X1 to 20X5, show the current and deferred tax impact in years 20X1 to 20X5 of the acquisition of the equipment.

See **Answer** at the end of this chapter.

See **Answer** at the end of this chapter.

12.1.2 Interest revenue

Please note the following key points.

- In some jurisdictions, interest revenue may be included in profit or loss on an accruals basis, but taxed when received.
- The temporary difference is equivalent to the income accrual at the reporting date, as the tax base of the interest receivable is nil.
- The resulting deferred tax is recognised in profit or loss.

12.1.3 Development costs

- Development costs may be capitalised for accounting purposes in accordance with IAS 38 while being deducted from taxable profit in the period incurred (ie, they receive immediate tax relief).
- The temporary difference is equivalent to the amount capitalised at the reporting date, as the tax base of the costs is nil since they have already been deducted from taxable profits.
- The resulting deferred tax is recognised in profit or loss.

12.1.4 Revaluations to fair value – property, plant and equipment

IFRS permits or requires some assets to be revalued to fair value, eg, property, plant and equipment under IAS 16, *Property, Plant and Equipment*.

Temporary difference

In some jurisdictions a revaluation will affect taxable profit in the current period. In this case, no temporary difference arises, as both carrying value and the tax base are adjusted.

In other jurisdictions, including the UK, the revaluation does not affect taxable profits in the period of revaluation and consequently, the tax base of the asset is not adjusted. Hence a temporary difference arises.

This should be provided for in full based on the difference between carrying amount and tax base.

An upward revaluation will therefore give rise to a deferred tax liability, even if:

- the entity does not intend to dispose of the asset; or
- tax due on any future gain can be deferred through rollover relief.

This is because the revalued amount will be recovered through use which will generate taxable income in excess of the depreciation allowable for tax purposes in future periods.

Manner of recovery

The carrying amount of a revalued asset may be recovered:

- through sale
- through continued use

The manner of recovery may affect the tax rate applicable to the temporary difference and/or the tax base of the asset. Interactive questions 2 and 3 within section 4.1.2 of this chapter provide illustrations of this.

Recording deferred tax

As the underlying revaluation is recognised as other comprehensive income, so the deferred tax thereon is also recognised as part of tax relating to other comprehensive income. The accounting entry is therefore:

DEBIT	Tax on other comprehensive income	X	
CREDIT	Deferred tax liability		X

Non-depreciated revalued assets

SIC 21, *Income Taxes – Recovery of Revalued Non-Depreciable Assets* requires that deferred tax should be recognised even where non-current assets are not depreciated (eg, land). This is because the carrying value will ultimately be recovered on disposal.

Worked example: Revaluation

A building in the UK was acquired on 1 January 20X2 at a cost of £500,000. It has been depreciated at a rate of 2% straight line and has also attracted tax allowances at a rate of 4% straight line. On 31 December 20X6, the building is revalued to £650,000. The tax rate is 30%.

Requirement

What are the deferred tax implications of the revaluation?

Solution

- The carrying amount of the building before the revaluation was £500,000 – (5 × 2% × £500,000) = £450,000.
- The tax base of the building before the revaluation was £500,000 – (5 × 4% × £500,000) = £400,000.
- The temporary difference of £50,000 would have resulted in a deferred tax liability of 30% × £50,000 = £15,000.
- As a result of the revaluation, the carrying amount of the building is increased to £650,000.
- The tax base does not change.
- The temporary difference therefore increases to £250,000 (£650,000 – £400,000), resulting in a total deferred tax liability of 30% × £250,000 = £75,000.
- As a result of the revaluation, additional deferred tax of £60,000 must therefore be recognised.
- This could also be calculated by applying the tax rate to the difference between carrying amount of £450,000 and valuation of £650,000.

12.1.5 Revaluations to fair value – other assets

IFRSs permit or require certain other assets to be revalued to fair value, for example:

- Certain financial instruments under IFRS 9, *Financial Instruments*
- Investment properties under IAS 40, *Investment Property*

Where the revaluation is recognised in **profit or loss** (eg, fair value through profit or loss instruments, investment properties) and the amount is taxable/allowable for tax, then no deferred tax arises as both the carrying value and the tax base are adjusted.

Where the revaluation is recognised as **other comprehensive income** (eg, many investments in equity instruments) and does not therefore impact taxable profits, then the tax base of the asset is not adjusted and deferred tax arises. This deferred tax is also recognised as other comprehensive income.

12.1.6 Retirement benefit costs

In the financial statements, retirement benefit costs are **deducted from accounting profit** as the service is provided by the employee. They are **not deducted in determining taxable profit** until the entity pays either retirement benefits or contributions to a fund. Thus a temporary difference may arise.

(a) A **deductible temporary difference** arises between the carrying amount of the net defined benefit liability and its tax base. The tax base is usually nil.

(b) The deductible temporary difference will normally **reverse**.

(c) A **deferred tax asset** is recognised for this temporary difference to the extent that it is recoverable; that is, sufficient profit will be available against which the deductible temporary difference can be used.

(d) If there is a net defined benefit asset, for example when there is a surplus in the pension plan, a **taxable temporary difference** arises and a **deferred tax liability** is recognised.

Under IAS 12, both current and deferred tax must be recognised outside profit or loss if the tax relates to items that are recognised outside profit or loss. This could make things complicated as it interacts with IAS 19, *Employee Benefits*.

IAS 19 (revised) requires recognition of remeasurement (actuarial) gains and losses in other comprehensive income in the period in which they occur.

It may be difficult to determine the amount of current and deferred tax that relates to items recognised in profit or loss or in other comprehensive income. As an approximation, current and deferred tax are allocated on an **appropriate basis**, often pro rata.

Context example: Context example: Defined benefit asset with a remeasurement loss

	Defined benefit asset	Current tax relief (28%)	Deferred tax liability (28%)
	£'000	£'000	£'000
Brought forward	1,000	-	(280)
Contributions	600	(168)	-
Profit or loss: net pension cost	(500)	140	-
OCI: actuarial loss	(200)	28	28
	(700)	168	28
Carried forward	900	-	252

Context example: Context example: Defined benefit liability with a remeasurement loss

	Defined benefit liability	Current tax relief (28%)	Deferred tax asset (28%)
	£'000	£'000	£'000
Brought forward	(2,000)	–	560
Contributions	1,200	(336)	–
Profit or loss: net pension cost	(1,000)	280	–
OCI: actuarial loss	(400)	56	56
	(1,400)	336	56
Carried forward	(2,200)	–	616

Worked example: Deferred tax and retirement benefits

Note: Look back to Chapter 18 on employee benefits to refresh your memory of how to account for pensions. In this example we look at how employee benefits and deferred tax interact.

Operating expenses in the draft accounts for Celia include £405,000 relating to the company's defined benefit pension scheme. This figure represents the contributions paid into the scheme in the year. No other entries have been made relating to this scheme. The figures included on the draft statement of financial position represent opening balances as at 1 October 20X5:

	£
Pension scheme assets	2,160,000
Pension scheme liabilities	(2,530,000)
	(370,000)
Deferred tax asset	121,000
	(249,000)

After the year end, a report was obtained from an independent actuary. This gave valuations as at 30 September 20X6 of:

	£
Pension scheme assets	2,090,200
Pension scheme liabilities	(2,625,000)

Other information in the report included:

Yield on high-quality corporate bonds	10%
Current service cost	£374,000
Payment out of scheme relating to employees transferring out	£400,000
Reduction in liability relating to transfers	£350,000
Pensions paid	£220,000

All receipts and payments into and out of the scheme can be assumed to have occurred on 30 September 20X6.

Celia recognises any gains and losses on remeasurement of defined benefit pension plans directly in other comprehensive income in accordance with IAS 19.

In the tax regime in which Celia operates, a tax deduction is allowed on payment of pension contributions. No tax deduction is allowed for benefits paid. Assume that the rate of tax applicable to 20X5, 20X6 and announced for 20X7 is 30%.

Requirements

1 Explain how each of the above transactions should be treated in the financial statements for the year ended 30 September 20X6.

2 Prepare an extract from the statement of profit or loss and other comprehensive income showing other comprehensive income for the year ended 30 September 20X6.

Solution

1 **Pensions**

1 The contributions paid have been charged to profit or loss in contravention of IAS 19, *Employee Benefits*.

Under IAS 19, the following must be done:

- Actuarial valuations of assets and liabilities revised at the year end
- All gains and losses recognised

In profit or loss	• Current service cost • Transfers • Net interest on net defined benefit liability
In other comprehensive income	• Remeasurement gains and losses

Deferred tax must also be recognised. Tax deductions are allowed on pension contributions. IAS 12, *Income Taxes* requires deferred tax relating to items charged or credited to other comprehensive income (OCI) to be recognised in other comprehensive income hence the amount of the deferred tax movement relating to the losses on remeasurement charged directly to OCI must be split out and credited directly to OCI.

2

Amounts recognised in other comprehensive income (extract)

	£
Actuarial loss on defined benefit obligation (W1)	(38,000)
Return on plan assets (excluding amounts in net interest) (W1)	(70,800)
	(108,800)
Deferred tax credit relating to actuarial losses on defined benefit plan (W2)	32,640
Other comprehensive income for the year	(76,160)

WORKINGS

(1) **Pension scheme**

	Pension scheme assets	Pension scheme liabilities
	£	£
At 1 October 20X5	2,160,000	2,530,000
Interest cost on obligation (10% × 2,530,000)		253,000

	Pension scheme assets	Pension scheme liabilities
	£	£
Interest on plan assets (10% × 2,160,000)	216,000	
Current service cost		374,000
Contributions	405,000	
Transfers	(400,000)	(350,000)
Pensions paid	(220,000)	(220,000)
Loss on remeasurement recognised in OCI	(70,800)	38,000
At 30 September 20X6	2,090,200	2,625,000

(2) **Deferred tax on pension liability**

		Current tax (P/L)	OCI	Deferred tax asset	Explanation
	£	£	£	£	
Net pension liability at 30 September 20X6 (2,530,000 – 2,160,000)	370,000			111,000	
Contribution	(405,000)	Cr (121,500)		(121,500)	Tax relief now given in the current tax charge, so it makes sense for this element of the movement to be in profit or loss
Profit and loss debits service cost 374,000 + interest costs 37,000	411,000	Dr 123,300		123,300	Also makes sense that the costs results increase in the deferred tax asset so this should go to profit or loss too
Transfers (400,000 – 350,000)	50,000	Dr 15,000		15,000	Because the liability increases the deferred tax asset increases
Loss on remeasurement to OCI	108,800		32,640	32,640	
Profit or loss/OCI movement		**16,800**	**32,640**	**49,440**	
Net pension liability/ deferred tax asset at 30 September 20X8	699,600			160,440	

12.1.7 Dividends receivable from UK and overseas companies

Note the following.

(a) Dividends received from UK and overseas companies are not taxable on UK companies.

(b) Overseas dividends are thus a permanent difference and so there is no deferred tax payable. (Previously dividends received by a UK company from an overseas company were taxable and hence were a temporary difference.)

12.2 Deductible temporary differences

12.2.1 Tax losses

Where tax losses arise, for example in the UK as trading losses or non-trading loan relationship deficits, then the manner of recognition of these in the financial statements depends on how they are expected to be used.

(a) If losses are **carried back** to crystallise a refund, then a receivable is recorded in the statement of financial position and the corresponding credit is to the current tax charge.

(b) If losses are **carried forward** to be used against future profits or gains, then they should be recognised as deferred tax assets to the extent that it is probable that future taxable profit will be available against which the losses can be used.

Unused tax credits carried forward against taxable profits will also give rise to a deferred tax asset to the extent that profits will exist against which they can be used.

Recognition of deferred tax asset

The existence of **unused tax losses** is strong evidence that future taxable profit may not be available. The following should be considered before recognising any deferred tax asset:

- Whether an entity has sufficient taxable temporary differences against which the unused tax losses can be offset
- Whether it is probable that the entity will have taxable profits before the unused tax losses expire
- Whether the tax losses result from identifiable causes which are unlikely to recur
- Whether tax planning opportunities are available to create taxable profit

Group tax relief

Where the acquisition of a subsidiary means that tax losses which previously could not be used can now be used against the profits of the subsidiary, a deferred tax asset may be recognised in the financial statements of the parent company. This amount is **not** taken into account in calculating goodwill arising on acquisition.

12.2.2 Provisions

- A provision is recognised for accounting purposes when there is a present obligation, but it is not deductible for tax purposes until the expenditure is incurred.
- In this case, the temporary difference is equal to the amount of the provision, since the tax base is nil.
- Deferred tax is recognised in profit or loss.

12.2.3 Share-based payments

Share-based transactions may be tax deductible in some jurisdictions. However, the amount deductible for tax purposes does not always correspond to the amount that is charged to profit or loss under IFRS 2.

In most cases it is not just the amount but also the timing of the expense allowable for tax purposes that will differ from that required by IFRS 2.

For example, an entity recognises an expense for share options granted under IFRS 2, but does not receive a tax deduction until the options are exercised. The tax deduction will be based on the share price on the exercise date and will be measured on the basis of the options' intrinsic value ie, the difference between market price and exercise price at the exercise date. In the case of share-based employee benefits under IFRS 2, the cost of the services as reflected in the financial statements is expensed and therefore the carrying amount is nil.

The difference between the carrying amount of nil and the tax base of share-based payment expense received to date is a deferred tax asset, provided the entity has sufficient future taxable profits to use this deferred tax asset.

The deferred tax asset temporary difference is measured as:

	£
Carrying amount of share-based payment expense	0
Less tax base of share-based payment expense	(X)
(estimated amount tax authorities will permit as a deduction in future periods, based on year-end information)	
Temporary difference	(X)
Deferred tax asset at X%	X

If the amount of the tax deduction (or estimated future tax deduction) exceeds the amount of the related cumulative remuneration expense, this indicates that the tax deduction also relates to an equity item.

The excess is therefore recognised directly in equity. The diagrams below show the accounting for equity-settled and cash-settled transactions.

IMAGE GOES HERE

Figure 22.3: Accounting for equity-settled and cash-settled transactions

Worked example: Deferred tax

On 1 January 20X2, an entity granted 5,000 share options to an employee vesting two years later on 31 December 20X3. The fair value of each option measured at the grant date was £3.

Tax law in the jurisdiction in which the entity operates allows a tax deduction of the intrinsic value of the options on exercise. The intrinsic value of the share options was £1.20 at 31 December 20X2 and £3.40 at 31 December 20X3, on which date the options were exercised.

Assume a tax rate of 30%.

Requirement

Show the deferred tax accounting treatment of the above transaction at 31 December 20X2, 31 December 20X3 (before exercise), and on exercise.

Solution

	31 Dec 20X2	31 Dec 20X3 before exercise
	£	£
Carrying amount of share-based payment expense	0	0
Less tax base of share-based payment expense	(3,000)	(17,000)
(5,000 × £1.2 ÷ 2)/(5,000 × £3.40)		
Temporary difference	(3,000)	(17,000)
Deferred tax asset @ 30%	900	5,100
Deferred tax (Cr profit) (5,100 – 900 – (Working) 600)	900	3,600
Deferred tax (Cr Equity) (Working)	0	600
On exercise, the deferred tax asset is replaced by a current tax asset.		

				31 Dec 20X2	31 Dec 20X3 before exercise
				£	£
The double entry is:		£			
DEBIT	deferred tax (profit)	4,500			
DEBIT	deferred tax (equity)	600			
CREDIT	deferred tax asset		5,100		
DEBIT	current tax asset	5,100			
CREDIT	current tax (profit)		4,500		
CREDIT	current tax (equity)		600		

WORKING

	£	£
Accounting expense recognised (5,000 × £3 ÷ 2)/(5,000 × £3)	7,500	15,000
Tax deduction	(3,000)	(17,000)
Excess temporary difference	0	(2,000)
Excess deferred tax asset to equity @ 30%	0	600

Interactive question 5: Share option scheme and deferred tax

Frost plc has the following share option scheme at 31 May 20X7:

Director's name	Grant date	Options granted	Fair value of options at grant date £	Exercise price £	Vesting date
Edmund Houston	1 June 20X5	40,000	3.00	4.00	6/20X7
Kieran Bullen	1 June 20X6	120,000	2.50	5.00	6/20X9

The price of the company's shares at 31 May 20X7 is £8 per share and at 31 May 20X6 was £8.50 per share.

The directors must be working for Frost on the vesting date in order for the options to vest.

No directors have left the company since the issue of the share options and none are expected to leave before June 20X9. The shares can be exercised on the first day of the month in which they vest.

In accordance with IFRS 2 an expense of £60,000 has been charged to profits in the year ended 31 May 20X6 in respect of the share option scheme. The cumulative expense for the two years ended 31 May 20X7 is £220,000.

Tax allowances arise when the options are exercised and the tax allowance is based on the option's intrinsic value at the exercise date.

Assume a tax rate of 30%.

Requirement

What are the deferred tax implications of the share option scheme?

See **Answer** at the end of this chapter.

See **Answer** at the end of this chapter.

12.2.4 Recognition of deferred tax assets for unrealised losses

This amendment was issued in January 2016 in order to clarify when a deferred tax asset should be recognised for unrealised losses. For example, an entity holds a debt instrument that is falling in value, without a corresponding tax deduction, but the entity knows that it will receive the full nominal amount on the due date, and there will be no tax consequences of that repayment. The question arises of whether to recognise a deferred tax asset on this unrealised loss.

The IASB clarified **that unrealised losses on debt instruments measured at fair value and measured at cost for tax purposes give rise to a deductible temporary difference** regardless of whether the debt instrument's holder expects to recover the carrying amount of the debt instrument by sale or by use.

This may seem to contradict the key requirement that an entity recognises deferred tax assets only if it is probable that it will have future taxable profits. However, the amendment also addresses the issue of what constitutes future taxable profits, and clarifies the following:

(a) The carrying amount of an asset does not limit the estimation of probable future taxable profits.

(b) Estimates for future taxable profits exclude tax deductions resulting from the reversal of deductible temporary differences.

(c) An entity assesses a deferred tax asset in combination with other deferred tax assets. Where tax law restricts the utilisation of tax losses, an entity would assess a deferred tax asset in combination with other deferred tax assets of the same type.

The amendment is effective from January 2017.

Worked example: Deferred tax asset and unrealised losses

(*Adapted from IAS 12, Illustrative Example 7*)

Humbert owns a debt instrument with a nominal value of £2,000,000. The fair value of the financial instrument at the company's year end of 30 June 20X4 is £1,800,000. Humbert has determined that there is a deductible temporary difference of £200,000. Humbert intends to hold the instrument until maturity on 30 June 20X5, and expects that the £2,000,000 will be paid in full. This means that the deductible temporary difference will reverse in full.

Humbert has, in addition, £60,000 of taxable temporary differences that will also reverse in full in 20X5. The company expects the bottom line of its tax return to show a tax loss of £40,000.

Assume a tax rate of 20%.

Requirement

Discuss, with calculations, whether Humbert can recognise a deferred tax asset under IAS 12, *Income Taxes*.

Solution

The first stage is to use the reversal of the taxable temporary difference to arrive at the amount to be tested for recognition.

Under IAS 12 Humbert will consider whether it has a tax liability from a taxable temporary difference that will support the recognition of the tax asset:

	£'000
Deductible temporary difference	200
Reversing taxable temporary difference	(60)
Remaining amount (recognition to be determined)	140

At least £60,000 may be recognised as a deferred tax asset.

The next stage is to calculate the future taxable profit. Following the amendment, this is done using a formula, the aim of which is to derive the amount of tax profit or loss before the reversal of any temporary difference:

	£'000
Expected tax loss (per bottom line of tax return)	(40)
Less reversing taxable temporary difference	(60)
Add reversing deductible temporary difference	200
Taxable profit for recognition test	100

Finally, the results of the above two steps should be added, and the tax calculated:

Humbert would recognise a deferred tax asset of (£60,000 + £100,000) × 20% = £32,000. This deferred tax asset would be recognised even though the company has an expected loss on its tax return.

13 Group scenarios

Section overview

- In relation to business combinations and consolidations, IAS 12 gives examples of circumstances that give rise to taxable temporary differences and to deductible temporary differences in an appendix.
- As already mentioned, however, the initial recognition of goodwill has no deferred tax impact.

14.1 General principles

There are some temporary differences which only arise in a business combination. This is because, on consolidation, adjustments are made to the carrying amounts of assets and liabilities that are not always reflected in the tax base of those assets and liabilities.

The tax bases of assets and liabilities in the consolidated financial statements are determined by reference to the applicable tax rules. Usually tax authorities calculate tax on the profits of the individual entities, so the relevant tax bases to use will be those of the individual entities. (*IAS 12.11*)

Deferred tax calculation

	$
Carrying amount of asset/liability	
(consolidated statement of financial position)	X/(X)
Tax base (usually subsidiary's tax base)	(X)/X
Temporary difference	X/(X)
Deferred tax (liability)/asset	(X)/X

14.2 Taxable temporary differences

14.2.1 Fair value adjustments on consolidation

IFRS 3, *Business Combinations* requires assets acquired on acquisition of a subsidiary to be recognised at their fair value rather than their carrying amount in the individual financial statements of the subsidiary. The fair value adjustment does not, however, have any impact on taxable profits or the tax base of the asset. This is much like a revaluation in an individual company's accounts.

Therefore an upwards fair value adjustment made to an asset will result in the carrying value of the asset exceeding the tax base and so a taxable temporary difference will arise.

The resulting deferred tax liability is recorded in the consolidated accounts by:

DEBIT	Goodwill (group share)	X	
CREDIT	Deferred tax liability		X

Worked example: Fair value adjustments

On 1 September 20X8, Hunt acquired 80% of the ordinary share capital of Harrison for consideration totalling £150,000. At the date of acquisition, Harrison's statement of financial position showed net assets of £180,000, although the fair value of inventory was assessed to be £10,000 above its carrying amount.

Requirement

Explain the deferred tax implications, assuming a tax rate of 30%.

Solution

- The carrying amount of the inventory in the group accounts is £10,000 more than its tax base (being carrying amount in Harrison's own accounts).
- Deferred tax on this temporary difference is 30% × £10,000 = £3,000.
- A deferred tax liability of £3,000 is recognised in the group statement of financial position.
- Goodwill is increased by (£3,000 × 80%) = £2,400.

14.2.2 Undistributed profits of subsidiaries, branches, associates and joint ventures

(a) The carrying amount of, for example, a subsidiary in consolidated financial statements is equal to the group share of the net assets of the subsidiary plus purchased goodwill.

(b) The tax base is usually equal to the cost of the investment.

(c) The difference between these two amounts is a temporary difference. It can be calculated as the parent's share of the subsidiary's post-acquisition profits which have not been distributed.

Worked example: Temporary difference in subsidiary holding

Askwith purchased 80% of the ordinary share capital of Embsay for £110,000 when the net assets of Embsay were £100,000, giving rise to goodwill of £30,000. At 31 December 20X6 the following is relevant:

(1) Goodwill has not been impaired.

(2) The net assets of Embsay amount to £120,000.

Requirement

What temporary difference arises on this investment at 31 December 20X6?

Solution

- The tax base of the investment in Embsay is the cost of £110,000. The carrying value is the share of net assets (80% × £120,000) + goodwill of £30,000 = £126,000.
- The temporary difference is therefore £126,000 – £110,000 = £16,000.
- This is equal to the group share of post-acquisition profits: 80% × £20,000 change in net assets since acquisition.

Recognition of deferred tax

A deferred tax liability should be recognised on the temporary difference unless:

- the parent/investor/venturer is able to control the timing of the reversal of the temporary difference; **and**

- it is probable that the temporary difference will not reverse (ie, the profits will not be paid out) in the foreseeable future.

This can be applied to different levels of investment as follows:

(a) **Subsidiary**

As a parent company can control the dividend policy of a subsidiary, deferred tax will not arise in relation to undistributed profits.

(b) **Associate**

An investor in an associate does not control that entity and so cannot determine its dividend policy. Without an agreement requiring that the profits of the associate should not be distributed in the foreseeable future, therefore, an investor should recognise a deferred tax liability arising from taxable temporary differences associated with its investment in the associate. Where an investor cannot determine the exact amount of tax, but only a minimum amount, then the deferred tax liability should be that amount.

(c) **Joint venture**

In a joint venture, the agreement between the parties usually deals with profit sharing. When a venturer can control the sharing of profits and it is probable that the profits will not be distributed in the foreseeable future, a deferred liability is not recognised.

14.2.3 Changes in foreign exchange rates

Where a foreign operation's taxable profit or tax loss (and therefore the tax base of its non-monetary assets and liabilities) is determined in a foreign currency, changes in the exchange rate give rise to taxable or deductible temporary differences.

These relate to the foreign entity's own assets and liabilities, rather than to the reporting entity's investment in that foreign operation, and so the reporting entity should recognise the resulting deferred tax liability or asset. The resulting deferred tax is charged or credited to profit or loss.

However, a deferred tax asset should **only** be recognised to the extent that both these are probable:

(a) That the temporary difference will **reverse** in the foreseeable future

(b) That **taxable profit** will be available against which the temporary difference can be used

14.3 Deductible temporary differences

14.3.1 Unrealised profits on intra-group trading

(a) From a tax perspective, one group company selling goods to another group company is taxed on the resulting profit in the period that the sale is made.

(b) From an accounting perspective no profit is realised until the recipient group company sells the goods to a third party outside the group. This may occur in a different accounting period from that in which the initial group sale is made.

(c) A temporary difference therefore arises equal to the amount of unrealised intra-group profit. This is the difference between the following:

   (1) Tax base, being cost to the recipient company (ie, cost to selling company plus unrealised intra-group profit on sale to the recipient company)

   (2) Carrying value to the group, being the original cost to the selling company, since the intra-group profit is eliminated on consolidation

(d) Deferred tax is provided at the **receiving** company's tax rate.

14.3.2 Fair value adjustments

IFRS 3 requires assets and liabilities acquired on acquisition of a subsidiary to be brought in at their fair value rather than the carrying amount. The fair value adjustment does not, however, have any impact on taxable profits or the tax base of the asset.

Therefore a fair value adjustment which increases a recognised liability or creates a new liability will result in the tax base of the liability exceeding the carrying value and so a deductible temporary difference will arise.

A deductible temporary difference also arises where an asset's carrying amount is reduced to a fair value less than its tax base.

The resulting deferred tax asset is recorded in the consolidated accounts by:

DEBIT	Deferred tax asset	X	
CREDIT	Goodwill		X

14.4 Deferred tax assets of an acquired subsidiary

Deferred tax assets of a subsidiary may not satisfy the criteria for recognition when a business combination is initially accounted for but may be realised subsequently.

These should be recognised as follows:

(a) If recognised within 12 months of the acquisition date and resulting from new information about circumstances existing at the acquisition date, the credit entry should be made to goodwill. If the carrying amount of goodwill is reduced to zero, any further amounts should be recognised in profit or loss.

(b) If recognised outside the 12-month 'measurement period' or not resulting from new information about circumstances existing at the acquisition date, the credit entry should be made to profit or loss.

Interactive question 6: Recognition

In 20X2 Jacko Co acquired a subsidiary, Jilly Co, which had deductible temporary differences of £3 million. The tax rate at the date of acquisition was 30%. The resulting deferred tax asset of £0.9 million was not recognised as an identifiable asset in determining the goodwill of £5 million resulting from the business combination. Two years after the acquisition, Jacko Co decided that future taxable profit would probably be sufficient for the entity to recover the benefit of all the deductible temporary differences.

Requirement

State the accounting treatment of the recognition of the deferred tax asset in 20X4.

See **Answer** at the end of this chapter.

See **Answer** at the end of this chapter.

Interactive question 7: Fair value adjustment

Oscar acquired 80% of the ordinary shares in Dorian Limited (Dorian) on 1 July 2005.

At acquisition, a property owned and occupied by Dorian had a fair value £30 million in excess of its carrying value. This property had a remaining useful life at that time of 20 years.

Oscar is preparing its financial statements as at 30 June 2015.

The tax rate in the jurisdiction in which Oscar operates is 16%.

Requirements

7.1 How should this fair value difference be recorded in the consolidated financial statements at 30 June 2015?

7.2 What is the deferred tax implication of the fair value adjustment?

See **Answer** at the end of this chapter.

See **Answer** at the end of this chapter.

Worked example: Deferred tax and groups 1

In recent years, Morpeth Ltd has made the following acquisitions of other companies:

- On 1 January 20X6, it acquired 90% of the share capital of Skipton, resulting in goodwill of £1.4 million.

- On 1 July 20X6 it acquired the whole of the share capital of Bingley for £6 million. At this date the fair value of the net assets of Bingley was £4.5 million and their tax base was £4 million.

The following information is relevant to Morpeth Group's year ended 31 December 20X6:

Skipton

(1) Skipton has made a provision amounting to £1.8 million in its accounts in respect of litigation. This is tax allowable only when the cost is actually incurred. The case is expected to be settled within 12 months.

(2) Skipton has a number of investments classified as at fair value through profit or loss in accordance with IFRS 9, *Financial Instruments*. The remeasurement gains and losses recognised in profit or loss for accounting purposes are not taxable/tax allowable until such date as the investments are sold. To date the cumulative unrealised gain is £2.5 million.

(3) Skipton has sold goods to Morpeth in the year making a profit of £1 million. A quarter of these goods remain in Morpeth's inventory at the year end.

Bingley

(1) At its acquisition date, Bingley had unrelieved brought-forward tax losses of £0.4 million. It was initially believed that Bingley would have sufficient taxable profits to use these losses and a deferred tax asset was recognised in Bingley's financial statements at acquisition. Subsequent events have proven that the future taxable profits will not be sufficient to use the full brought-forward loss.

(2) At acquisition Bingley's retained earnings amounted to £3.5 million. The directors of Morpeth Group have decided that in each of the next four years to the intended listing date of the group, they will realise earnings through dividend payments from the subsidiary amounting to £600,000 per annum. Bingley has not declared a dividend for the current year. Tax is payable on remittance of dividends.

(3) £300,000 of the purchase price of Bingley has been allocated to intangible assets. The recognition and measurement criteria of IFRS 3 and IAS 38 do not appear to have been met; however, the directors believe that the amount is allowable for tax and have calculated the tax charge accordingly. It is believed that this may be challenged by the tax authorities.

Requirement

What are the deferred tax implications of the above issues for the Morpeth Group?

Solution

Acquisitions

Any fair value adjustments made for consolidation purposes will affect the group deferred tax charge for the year.

A taxable temporary difference will arise where the fair value of an asset exceeds its carrying value, and the resulting deferred tax liability should be recorded against goodwill.

A deductible temporary difference will arise where the fair value of a liability exceeds its carrying value, or an asset is revalued downwards. Again the resulting deferred tax amount (an asset) should be recognised in goodwill.

In addition, it may be possible to recognised deferred tax assets in a group which could not be recognised by an individual company. This is the case where tax losses brought forward, but not considered to be an asset, due to lack of available taxable profits to set them against, can now be used by another group company.

Goodwill

Goodwill arose on both acquisitions. According to IAS 12, however, no provision should be made for the temporary difference arising on this.

Skipton

(1) A deductible temporary difference arises when the provision is first recognised. This results in a deferred tax asset calculated as £540,000 (30% × £1.8m). The asset may, however, only be recognised where it is probable that there will be future taxable profits against which the future tax-allowable expense may be set. There is no indication that this is not the case for Skipton.

(2) A taxable temporary difference arises where investments are revalued upwards for accounting purposes but the uplift is not taxable until disposal. In this case the carrying value of the investments has increased by £2.5 million, and this has been recognised in profit or loss. The tax base has not, however changed. Therefore, a deferred tax liability should be recognised on the £2.5 million, and, in line with the recognition of the underlying revaluation, this should be recognised in profit or loss.

(3) This intra-group transaction results in unrealised profits of £250,000 which will be eliminated on consolidation. The tax on this £250,000 will, however, be included within the group tax charge (which is comprised of the sum of the individual group companies' tax charges). From the perspective of the group there is a temporary difference. Deferred tax should be provided on this difference using the tax rate of Morpeth (the recipient company).

Bingley

(1) Unrelieved tax losses give rise to a deferred tax asset only where the losses are regarded as recoverable. They should be regarded as recoverable only where it is probable that there will be future taxable profits against which they may be used. It is indicated that the future profits of Bingley will not be sufficient to realise all of the brought-forward loss, and therefore the deferred tax asset is calculated only on that amount expected to be recovered.

(2) Deferred tax is recognised on the unremitted earnings of investments, except where:

    (a) The parent is able to control the payment of dividends

    (b) It is unlikely that the earnings will be paid out in the foreseeable future

    Morpeth controls Bingley and is therefore able to control its dividend payments; however, it is indicated that £2.4 million will be paid as dividends in the next four years. Therefore a deferred tax liability related to this amount should be recognised.

(3) The directors have assumed that the £300,000 relating to intangible assets will be tax allowable, and the tax provision has been calculated based on this assumption. However, this is not certain, and extra tax may have to be paid if this amount is not allowable. Therefore a liability for the additional tax amount should be recognised.

Interactive question 8: Intangible

Jenner Holdings (Jenner) operates in the recruitment industry. On 1 February 20X0, Jenner acquired 60% of Rannon. It is now 31 March 20X4, and the consolidated financial statements of Jenner are being prepared.

On the date of acquisition, £40,800,000 of the purchase consideration was allocated to the domain name 'www.alphabettajob.com' which Rannon had registered some years earlier. www.alphabettajob.com HYPERLINK "http://www.alphabettajob.com" www.alphabettajob.com is well known in the recruitment industry and a popular job search website and as a result Jenner was able to establish a fair value using an income-based valuation method. The domain name is not recognised in Rannon's individual financial statements and has a tax base of nil.

The Jenner Group amortises acquired domain names over 10 years. The tax rate applicable to the profits of both companies is 17%.

Requirement

Prepare journals and explanations to show how this domain name should be treated in the consolidated financial statements of the Jenner Group as at 31 March 20X4.

See **Answer** at the end of this chapter.

See **Answer** at the end of this chapter.

Interactive question 9: Deferred tax and groups

Menston, a limited company, has two wholly owned subsidiaries, Burley, another UK company and Rhydding, which is located in Estomania. The following information is relevant to the year ended 31 August 20X8:

(1) Rhydding has made a tax-adjusted loss equivalent to £6.5 million. This loss can only be relieved through carry forward against future profits of Rhydding.

(2) During the year Burley has sold goods to Menston for £12 million, based on a 20% mark-up. Half of these goods are still in Menston's stock room at the year end.

Assume that the tax rate applicable to the group companies based in the UK is 30%; the Estomanian tax rate is 20%.

Requirement

What are the deferred tax implications of these issues?

See **Answer** at the end of this chapter.

See **Answer** at the end of this chapter.

Interactive question 10: Deferred tax scenarios

Angelo, a public limited company, has three 100% owned subsidiaries, Claudio, Lucio and Escalus SA, a foreign subsidiary.

(1) The following details relate to Claudio:

  (a) Angelo acquired its interest in Claudio on 1 January 20X3. The fair values of the assets and liabilities acquired were considered to be equal to their carrying amounts, with the exception of freehold property which was considered to have a fair value of £1 million in excess of its book value. The directors have no intention of selling the property.

  (b) Claudio has sold goods at a price of £6 million to Angelo since acquisition and made a profit of £2 million on the transaction. The inventories of these goods recorded in Angelo's statement of financial position at the year end, 30 September 20X3, were £3.6 million.

(2) Lucio undertakes various projects from debt factoring to investing in property and commodities. The following details relate to Lucio for the year ended 30 September 20X3:

  (a) Lucio has a portfolio of readily marketable government securities which are held as current assets for financial trading purposes. These investments are stated at market value in the statement of financial position with any gain or loss taken to profit or loss. These gains and losses are taxed when the investments are sold. Currently the accumulated unrealised gains are £8 million.

  (b) Lucio has calculated it requires an allowance for credit losses of £2 million against its total loan portfolio. Tax relief is available when a specific loan is written off.

  (c) Escalus SA has unremitted earnings of €20 million which would give rise to additional tax payable of £2 million if remitted to Angelo's tax regime. Angelo intends to leave the earnings within Escalus for reinvestment.

  (d) Angelo has unrelieved trading losses as at 30 September 20X3 of £10 million.

Current tax is calculated based on the individual company's financial statements (adjusted for tax purposes) in the tax regime in which Angelo operates. Assume an income tax rate of 30% for Angelo and 25% for its subsidiaries.

Requirement

Explain the deferred tax implications of the above information for the Angelo group of companies for the year ended 30 September 20X3.

See **Answer** at the end of this chapter.

See **Answer** at the end of this chapter.

Interactive question 11: Foreign branch

Investa has a foreign branch which has the same functional currency as Investa (the pound sterling). The branch's taxable profits are determined in dinars. On 1 May 20X3, the branch acquired a property for 6 million dinars. The property had an expected useful life of 12 years with a zero residual value. The asset is written off for tax purposes over eight years. The tax rate in Investa's jurisdiction is 30% and in the branch's jurisdiction is 20%. The foreign branch uses the cost model for valuing its property and measures the tax base at the exchange rate at the reporting date.

Investa would like an explanation (including a calculation) as to why a deferred tax charge relating to the asset arises in the group financial statements for the year ended 30 April 20X4 and the impact on the financial statements if the tax base had been translated at the historical rate.

The exchange rate was 5 dinars: £1 on 1 May 20X3 and 6 dinars: £1 on 30 April 20X4.

Requirement

Provide the explanation and calculation requested.

See **Answer** at the end of this chapter.

See **Answer** at the end of this chapter.

15 Presentation and disclosure

Section overview

The detailed presentation and disclosure requirements for current and deferred tax are given below.

16.1 Disclosure requirements

The tax expense (income) related to profit (or loss) from ordinary activities should be presented on the face of the statement of profit or loss and other comprehensive income.

The following are the main items that should be disclosed separately:

(a) Current tax expense (income)

(b) Any adjustments recognised in the period for current tax of prior periods

(c) The amount of deferred tax expense (income) relating to temporary differences

(d) The amount of deferred tax expense (income) relating to changes in tax rates or the imposition of new taxes

(e) Prior period deferred tax or current tax adjustments

(f) The aggregate current and deferred tax relating to items that are charged or credited to equity

(g) An explanation of the relationship between tax expense (income) and accounting profit which can be done in either (or both) of the following ways:

  (1) A numerical reconciliation between tax expense and the product of accounting profit multiplied by the applicable tax rate(s), disclosing also the basis on which the applicable tax rate (s) is (are) computed

  (2) A numerical reconciliation between the average effective tax rate and the applicable tax rate, disclosing also the basis on which the applicable tax rate is computed

(h) An explanation of changes in the applicable tax rate(s) compared to the previous accounting period

(i) The amount of deductible temporary differences, unused tax losses and unused tax credits for which no deferred tax asset is recognised in the statement of financial position

16.2 The statement of financial position

Tax assets and tax liabilities should be presented separately from other assets and liabilities in the statement of financial position. Deferred tax assets and liabilities should be distinguished from current tax assets and liabilities.

Deferred tax assets (liabilities) should **not** be classified as current assets (liabilities). This is the case even if the deferred tax assets/liabilities are expected to be realised within 12 months.

There is no requirement in IAS 12 to disclose the tax base of assets and liabilities on which deferred tax has been calculated.

16.2.1 Offsetting

Where appropriate deferred tax assets and liabilities should be offset in the statement of financial position.

An entity should offset deferred tax assets and deferred tax liabilities if, and only if:

- the entity has a legally enforceable right to set off current tax assets against current tax liabilities; and
- the deferred tax assets and the deferred tax liabilities relate to income taxes levied by the same taxation authority.

There is no requirement in IAS 12 to provide an explanation of assets and liabilities that have been offset.

16.2.2 Other disclosures

An entity should disclose any tax-related contingent liabilities, and contingent assets, in accordance with IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*. Contingent liabilities and contingent assets may arise, for example, from unresolved disputes with the taxation authorities.

Similarly, where changes in tax rates or tax laws are enacted or announced after the reporting date, an entity should disclose any significant effect of those changes on its current and deferred tax assets and liabilities (*see IAS 10, Events After the Reporting Period*).

Interactive question 12: Tax adjustment

In the notes to the financial statements of Tacks for the year ended 30 November 20X2, the tax expense included an amount in respect of 'Adjustments to current tax in respect of prior years' and this expense has been treated as a prior year adjustment. These items related to adjustments arising from tax audits by the authorities in relation to previous reporting periods.

The issues that resulted in the tax audit adjustment were not a breach of tax law but related predominantly to transfer pricing issues, for which there was a range of possible outcomes that were negotiated during 20X2 with the taxation authorities. Further at 30 November 20X1, Tacks had accounted for all known issues arising from the audits to that date and the tax adjustment could not have been foreseen as at 30 November 20X1, as the audit authorities changed the scope of the audit. No penalties were expected to be applied by the taxation authorities.

Requirement

What is the correct treatment of the above issue in the financial statements for the year ended 30 November 20X2?

See **Answer** at the end of this chapter.

See **Answer** at the end of this chapter.

17 Deferred tax summary and practice

- The calculation and recording of deferred tax can be set out in an eight-step process.
- Deferred tax at Advanced Level will be much more demanding than at Professional Level.

18.1 Summary

The following is a summary of the steps required to calculate and record deferred tax in the financial statements.

	Procedure	Comment
Step 1	Determine the carrying amount of each asset and liability in the statement of financial position.	This is merely the carrying value determined by other standards.
Step 2	Determine the tax base of each asset and liability.	This is the amount attributed to each asset or liability for tax purposes.
Step 3	Determine any temporary differences (these are based on the difference between the figures in Step 1 and Step 2).	These will be either: • Taxable temporary differences; or • Deductible temporary differences.
Step 4	Determine the deferred tax balance by multiplying the tax rate by any temporary differences.	The tax rate to be used is that expected to apply when the asset is realised or the liability settled, based on laws already enacted or substantively enacted by the statement of financial position date.
Step 5	Recognise deferred tax assets/liabilities in the statement of financial position.	Apply recognition criteria in IAS 12.
Step 6	Recognise deferred tax, normally in profit or loss (but possibly as other comprehensive income or in equity or goodwill).	This will be the difference between the opening and closing deferred tax balances in the statement of financial position.
Step 7	Offset deferred tax assets and liabilities in the statement of financial position where appropriate.	Offset criteria in IAS 12 must be satisfied.
Step 8	Comply with relevant presentation and disclosure requirements for deferred tax in IAS 12.	See relevant presentation and disclosure requirements sections above.

The method described is referred to as the liability method, or full provision method.

(a) The **advantage** of this method is that it recognises that each temporary difference at the reporting date has an effect on future tax payments, and these are provided for in full.

(b) The **disadvantage** of this method is that, under certain types of tax system, it gives rise to large liabilities that may fall due only far in the future.

18.2 Exam-standard question practice

While UK tax is not specifically examinable at Advanced Level, deferred tax is still an important topic. The interactive question below is exam-standard and, in addition to testing deferred tax in depth, also tests foreign currency translation of a non-monetary asset and impairment of a previously revalued asset, a financial instrument and a provision. Finally it asks for a re-draft of a statement of financial position following adjustments, which is a typical feature of Question 2 of the Corporate Reporting exam.

Interactive question 13: Exam-standard question

You are Richard Carpenter, a newly-qualified ICAEW Chartered Accountant, working in the finance department at Chippy plc, a sportswear company with a number of subsidiaries in the UK and overseas. On 1 October 20X2, Chippy acquired 100% of the ordinary shares of Marusa Inc, a sportswear company based in Ruritania. The national currency of Ruritania is the krown (Kr).

You receive the following email from Ying Cha, the finance director of Chippy:

To: Richard Carpenter

From: Ying Cha

Date: 4 November 20X3

Subject: Marusa financial statements for the year ended 30 September 20X3 and advice on parent company transactions

Richard,

Marusa's finance director, Sian Parsons, has provided a draft statement of financial position which has been prepared using Ruritanian GAAP (**Exhibit 1**). This needs to be restated using IFRS before we consolidate Marusa's results. Marusa achieved break-even for the year and the company has no current tax liability.

Sian has also prepared some notes (**Exhibit 2**) that detail key transactions for the year ended 30 September 20X3.

There is no deferred tax under Ruritanian GAAP, but I am particularly concerned about the deferred tax implications of some of the key transactions under IFRS.

I would also like your advice regarding the deferred tax treatment of a UK subsidiary in the financial statements of Chippy, the parent company. I have prepared a note on the relevant issue (**Exhibit 3).**

I would like you to do the following:

- For each of the key transactions (Exhibit 2):
  - Explain any adjustments which need to be made to ensure that Marusa's financial statements comply with IFRS
  - Prepare the journal entries needed to adjust Marusa's financial statements to IFRS
- Prepare a revised statement of financial position for Marusa at 30 September 20X3 in accordance with IFRS, showing all workings clearly.
- Explain the deferred tax treatment relating to the subsidiary in the financial statements of Chippy.

Please prepare your figures to the nearest Kr'000.

Requirement

Respond to Ying Cha's instructions.

See **Answer** at the end of this chapter.

Exhibit 1: Marusa – Draft statement of financial position at 30 September 20X3

	Kr'000
Non-current assets	
Property, plant & equipment	61,600
Intangible assets	8,500
Financial investments	7,700
	77,800
Current assets	23,700
	101,500
Equity and liabilities	
Equity	

	Kr'000
Non-current assets	
Share capital Kr1 shares	10,000
Retained earnings	42,600
Revaluation surplus	16,800
	69,400
Non-current liabilities	
Loans	10,000
Provisions	15,000
Current liabilities	7,100
	101,500

Exhibit 2: Notes prepared by Sian Parsons: Key transactions in the year ended 30 September 20X3

(1) **Purchase of machinery**

On 1 January 20X3 Marusa bought some specialist machinery from the USA for $30 million. Payment for the machinery was made on 31 March 20X3.

In accordance with local Ruritanian GAAP, I recognised the cost of the machinery on 1 January 20X3 at Kr10 million, using the opening rate of exchange at 1 October 20X2.

I have charged a full year's depreciation of Kr1.0 million in cost of sales, as Marusa depreciates the machinery over a 10-year life and it has no residual value. I have therefore included the machinery in the statement of financial position at Kr9 million.

An amount of Kr2.5 million has been debited to retained earnings. This is in respect of the difference between the sum paid to the supplier of Kr12.5 million on 31 March 20X3 and the cost recorded in non-current assets of Kr10 million.

The Kr/US$ exchange rates on relevant dates were:

	1 Kr =
1 October 20X2	$3.00
1 January 20X3	$2.50
31 March 20X3	$2.40
30 September 20X3	$2.00

In Ruritania the tax treatment of property, plant and equipment and exchange differences is the same as the IFRS treatment.

(2) **Impairment**

Marusa bought a warehouse on 1 October 20W3 for Kr36 million. The warehouse is being depreciated over 20 years with no residual value. On 1 October 20X2, due to a rise in property prices, the warehouse was revalued to Kr42 million and a revaluation surplus of Kr16.8 million was recognised. No transfers are made between the revaluation surplus and retained earnings under Ruritanian GAAP in respect of depreciation.

There has been a slump in the local property market recently, so an impairment review was undertaken at 30 September 20X3, and the warehouse was assessed as being worth Kr12 million. I have therefore charged Kr18 million to profit or loss to reflect the difference between the carrying amount of the warehouse of Kr30 million before 30 September 20X3 and the new value of Kr12 million.

(3) **Investment**

On 1 April 20X3, Marusa bought one million shares in a local listed company for Kr7.70 per share. This represents a 3% shareholding. The intention is to hold the shares until 31 December 20X3, and then sell them at a profit. I have recognised the shares at cost in the statement of financial position in accordance with Ruritanian GAAP. The market value of the shares at 30 September 20X3 was Kr12.50 per share.

Under Ruritanian tax rules, income tax is charged at 20% on the accounting profit recognised on the sale of the investment.

(4) **Provision**

On 1 October 20X2, Marusa signed an agreement with the Ruritanian government for exclusive rights for the next 20 years to the organic cotton grown on government-owned land. The cost of buying these rights was Kr8.5 million, which has been recognised in intangible assets in Marusa's statement of financial position. Under the terms of the rights agreement, Marusa has to repair any environmental damage at the end of the 20-year period.

There is a 40% probability of the eventual cost of environmental repairs being Kr15 million and a 60% probability of the cost being Kr10 million. To be prudent I have created a provision for Kr15 million, and debited this to operating costs. Marusa has a pre-tax discount rate of 8%. The environmental costs will be allowed for tax purposes when paid. The income tax rate is expected to remain at 20%.

Exhibit 3: Note prepared by Ying Cha: Key transactions in the year ended 30 September 20X3

Gemex, a limited liability company, is a wholly owned UK subsidiary of Chippy, and is a cash generating unit in its own right. The value of the property, plant and equipment of Gemex at 30 September 20X3 was £6 million and purchased goodwill was £1 million before any impairment loss. The company had no other assets or liabilities. An impairment loss of £1.8 million had occurred at 30 September 20X3. The tax base of the property, plant and equipment of Gemex was £4 million as at 30 September 20X3.

I would like to know how the impairment loss will affect the deferred tax liability for the year in the financial statements of Chippy. Impairment losses are not an allowable expense for taxation purposes under UK tax. The UK corporation tax rate is 20%.

See **Answer** at the end of this chapter.

19 Audit focus

Section overview

- The provision for and related statement of profit or loss entries for deferred taxation are based on assumptions that rely on management judgements.
- Procedures should be adopted to ensure any assumptions are reasonable and the requirements of IAS 12 have been met.

20.1 Auditing tax

20.1.1 Audit risks

Until recently, tax accounting has been of secondary concern in the corporate group reporting process. The tax figures in the financial statements are, however, often material by their nature, and the increased public interest around tax avoidance now places greater pressure on companies and groups to get tax reporting right.

The following factors increase the audit risk in respect of current and deferred tax, particularly in a group reporting context:

- Lack of tax accounting knowledge: even in larger groups with in-house tax specialist resource, the board is often more interested in the cash cost of tax than in tax accounting, although getting the tax rate in line with analysts' expectations does still promote investor confidence.

- Lack of foreign tax knowledge: the tax figures of foreign operations are particularly at risk of misstatement, and auditing them may require specialist knowledge.
- Complex or unusual transactions: the tax implications of such transactions may be overlooked by management, but they can be complex and material.
- Lack of appropriate tax reporting processes: the basic processes (such as Excel spreadsheets) used by many entities are unable to respond to complex tax reporting requirements. The use of manual input increases the risk of errors, and may render workings difficult to audit.

20.1.2 Use of tax specialists

On the audit of larger or more complex entities, tax audit specialists are likely to be actively involved from the start of the audit as members of the audit team, using their tax accounting expertise to carry out the review of tax figures in the statement of financial position and statement of profit or loss. In such cases, the tax audit team will report their findings, including any identified misstatements and any areas of significant uncertainty, to the audit team. The tax team's workings papers must be included within the audit working papers file.

Note: In accordance with the FRC's revised Ethical Standard the provision of tax services by an audit firm for PIEs is prohibited.

20.1.3 Current tax: audit procedures

Auditors (or the tax specialists involved in the audit) should carry out audit procedures including the following:

- Obtain copies of the prior period tax computation.
- Inquire whether any tax enquiries have been raised by the tax authorities in the period.
- Inquire into the status of any unresolved tax enquiries, and obtain supporting correspondence with the tax authorities.
- Obtain copies of the current period tax computation, and evaluate whether:
  - the opening balances agree to the closing balances in the prior period tax computation;
  - the figures in the tax computation agree to figures in the financial statements;
  - estimates contained within the tax computation are based on reasonable assumptions; and
  - all tax rates and allowances are based on applicable tax legislation.
- Review details of tax payments made/refunds received in the period, and agree payments to the cash and bank account.

20.1.4 Deferred tax: audit procedures

The following procedures will be relevant:

- Assess whether it is appropriate for the company to recognise deferred tax (eg, is the company expected to make future taxable profits against which the deferred tax would unwind?).
- Obtain a copy of the deferred tax workings.
- Determine the arithmetical **accuracy** of the deferred tax working.
- Agree the **figures used** to calculate temporary differences to those on the **tax computation** and the **financial statements.**
- Review the assumptions made in the light of the auditor's knowledge of the business and any other evidence gathered during the course of the audit to ensure reasonableness.
- Agree the opening position on the deferred tax account to the prior year financial statements.
- Review the basis of the provision to ensure:
  - it is in line with accounting practice under IAS 12, *Income Taxes*; and
  - any changes in accounting policy have been disclosed.
- Verify that the rate of corporation tax at which the deferred tax asset/liability unwinds is appropriate and in line with current tax legislation.
- To test for **completeness** (understatement) the auditor should review the draft financial statements to identify items that would normally be expected to give a temporary difference and ensure they have been included.

20.1.5 Transfer pricing

Besides auditing current and deferred tax, transfer pricing is an important area over which sufficient appropriate audit evidence must be sought. When the entity's transfer pricing policies are challenged by the tax authorities, the effect on the company's current tax position over several years is likely to be material.

Please refer to Chapter 20 for a more detailed discussion of transfer pricing.

Context example: Context example: Petrofac plc

Petrofac plc is a global oil and gas services company, listed on FTSE 250. In the group financial statements for the year ended 31 December 2014, tax accounting was identified as an area of particular audit risk by the group auditor, Ernst & Young. The following excerpts from the auditor's report for the period describe the risk, and the audit team's responses to the risk.

Accounting for taxation assets, liabilities, income and expenses

Area of risk

The wide geographical spread of the Group's operations, the complexity of application of local tax rules in many different jurisdictions and transfer pricing risks affecting the allocation of income and costs charged between jurisdictions and businesses increase the risk of misstatement of tax balances. The assessment of tax exposures by Management requires judgement given the structure of individual contracts and the increasing activity of tax authorities in the jurisdictions in which Petrofac operates. Furthermore, the recognition of deferred tax assets and liabilities needs to be reviewed regularly to ensure that any changes in local tax laws and profitability of associated contracts are appropriately considered. Refer to note 7 of the financial statements for disclosures in respect of taxation for the year.

Audit approach

We used tax specialists in our London team in the planning stages to determine which jurisdictions should be in scope, as well as in the audit of tax balances. We also involved local tax specialists in the relevant jurisdictions where we deemed it necessary. We considered and challenged the tax exposures estimated by management and the risk analysis associated with these exposures along with claims or assessments made by tax authorities to date. We also audited the calculation and disclosure of current and deferred tax (refer to Note 7) to ensure compliance with local tax rules and the Group's accounting policies including the impact of complex items such as share based payments and the review of management's assessment of the likelihood of the realisation of deferred tax balances.

Summary

Summary

IMAGE GOES HERE

Technical reference

1 **IAS 12, Income Taxes**

2 **Tax base of an asset/liability - IAS 12.7, IAS 12.8**

3 **Current tax**

- Unpaid current tax recognised as a liability - IAS 12.12
- Benefit relating to tax losses that can be carried back to recover previous period current tax recognised as asset - IAS 12.13

4 **Taxable temporary differences**

- Deferred tax liability shall be recognised on all taxable temporary differences except those arising from: - IAS 12.15
  - Initial recognition of goodwill
  - Initial recognition of an asset or liability in a transaction which:
    - Is not a business combination, and
    - At the time of the transaction affects neither accounting profit nor taxable profit (tax loss)

5 **Deductible temporary differences**

- Deferred tax asset shall be recognised for all deductible temporary differences to the extent that taxable profit will be available to be used, unless asset arises from initial recognition of asset or liability in a transaction that: - IAS 12.24
  - Is not a business combination, and
  - At the time of the transaction affects neither accounting profit nor taxable profit or loss

6 **Unused tax losses and unused tax credits**

- Deferred tax asset may be recognised in respect of unused tax losses and unused tax credits to the extent that future taxable profits will be available - IAS 12.34

7 **Deferred tax assets and liabilities arising from investments in subsidiaries, branches and associates and investments in joint ventures - IAS 12.39, IAS 12.44**

8 **Tax rates and manner of recovery**

- Measurement of deferred tax at tax rates expected to apply when asset realised or liability settled to reflect tax consequences of manner of recovery - IAS 12.47

  - IAS 12.51

9 **Discounting**

- Deferred tax assets and liabilities shall not be discounted - IAS 12.53

10 **Annual review**

- Carrying amount of deferred tax asset to be reviewed at each reporting date - IAS 12.56

Self-test questions

Answer the following questions.

1 Torcularis

The Torcularis Company has interest receivable which has a carrying amount of £75,000 in its statement of financial position at 31 December 20X6. The related interest revenue will be taxed on a cash basis in 20X7.

Torcularis has trade receivables that have a carrying amount of £80,000 in its statement of financial position at 31 December 20X6. The related revenue has been included in its statement of profit or loss and other comprehensive income for the year to 31 December 20X6.

Requirement

According to IAS 12, *Income Taxes*, what is the total tax base of interest receivable and trade receivables for Torcularis at 31 December 20X6?

. What will the following situations give rise to as regards deferred tax, according to IAS 12, *Income Taxes*?

(1) Development costs have been capitalised and will be amortised through profit or loss, but were deducted in determining taxable profit in the period in which they were incurred.

(2) Accumulated depreciation for a machine in the financial statements is greater than the cumulative capital allowances up to the reporting date for tax purposes.

A penalty payable is in the statement of financial position. Penalties are not allowable for tax purposes.

2 Budapest

On 31 December 20X6, The Budapest Company acquired a 60% stake in The Lisbon Company. Among Lisbon's identifiable assets at that date was inventory with a carrying amount of £8,000 and a fair value of £12,000. The tax base of the inventory was the same as the carrying amount.

The consideration given by Budapest resulted in the recognition of goodwill acquired in the business combination.

Income tax is payable by Budapest at 25% and by Lisbon at 20%.

Requirement

Indicate whether the following statements are true or false, in respect of Budapest's consolidated statement of financial position at 31 December 20X6, in accordance with IAS 12, *Income Taxes*.

(1) No deferred tax liability is recognised in respect of the goodwill.

(2) A deferred tax liability of £800 is recognised in respect of the inventory.

3 Dipyrone

The Dipyrone Company owns 100% of the Reidfurd Company. During the year ended 31 December 20X7:

(1) Dipyrone sold goods to Reidfurd for £600,000, earning a profit margin of 25%. Reidfurd held 30% of these goods in inventory at the year end.

(2) Reidfurd sold goods to Dipyrone for £800,000, earning a profit margin of 20%. Dipyrone held 25% of these goods in inventory at the year end.

The tax base of the inventory in each company is the same as its carrying amount. The tax rate applicable to Dipyrone is 26% and that applicable to Reidfurd is 33%.

Requirement

What is the deferred tax asset at 31 December 20X7 in Dipyrone's consolidated statement of financial position under IAS 12, *Income Taxes* and IFRS 10, *Consolidated Financial Statements*?

4 Rhenium

The Rhenium Company issued £6 million of 8% loan stock at par on 1 April 20X7. Interest is payable in two instalments on 30 September and 31 March each year.

The company pays income tax at 20% in the year ended 31 December 20X7, but expects to pay at 25% for 20X8 as it will be earning sufficient profits to pay tax at the higher rate.

For tax purposes interest paid and received is dealt with on a cash basis.

Requirement

What is the deferred tax balance at 31 December 20X7, according to IAS 12, *Income Taxes*?

5 Cacholate

The Cacholate Company acquired a property on 1 January 20X6 for £1.5 million. The useful life of the property is 20 years, which is also the period over which tax depreciation is charged.

On 31 December 20X7, the property was revalued to £2.16 million. The tax base remained unaltered.

Income tax is payable at 20%.

Requirement

What is the deferred tax charge for the year ended 31 December 20X7, and where is it charged, under IAS 12, *Income Taxes*?

6 Spruce

Spruce Company made a taxable loss of £4.7 million in the year ended 31 December 20X7. This was due to a one-off reorganisation charge in 20X7; before that, Spruce made substantial taxable profits each year.

Assume that tax legislation allows companies to carry back tax losses for one financial year, and then carry them forward indefinitely.

Spruce's taxable profits are as follows.

Year ended	**£'000**
31 December 20X6	500
31 December 20X8 (estimate)	1,000
31 December 20X9 (estimate)	1,200
31 December 20Y0 and onwards	Uncertain

Spruce pays income tax at 25%.

Requirement

What is the deferred tax balance in respect of tax losses in Spruce's statement of financial position at 31 December 20X7, according to IAS 12, *Income Taxes*?

7 Bananaquit

At 31 December 20X6, The Bananaquit Company has a taxable temporary difference of £1.5 million in relation to certain non-current assets.

At 31 December 20X7, the carrying amount of those non-current assets is £2.4 million and the tax base of the assets is £1.0 million.

Tax is payable at 30%.

Indicate whether the following statements are true or false, in accordance with IAS 12, *Income Taxes*.

(1) The deferred tax charge through profit or loss for the year is £30,000.

(2) The statement of financial position deferred tax asset at 31 December 20X7 is £420,000.

8 Antpitta

The Antpitta Company owns 70% of The Chiffchaff Company. During 20X7 Chiffchaff sold goods to Antpitta at a mark-up above cost. Half of these goods are held in Antpitta's inventories at the year end. The rate of income tax is 30%.

Indicate whether the following statements are true or false according to IAS 12, *Income Taxes* and IFRS 10, *Consolidated Financial Statements*, when preparing Antpitta's consolidated and Chiffchaff's individual financial statements for the year ended 31 December 20X7.

(1) A deferred tax asset arises in the individual statement of financial position of Chiffchaff in relation to intra-group transactions.

(2) A deferred tax asset arises in Antpitta's consolidated statement of financial position due to the intra-group transactions.

9 Parea

In order to maximise its net assets per share, The Parea Company wishes to recognise the minimum deferred tax liability allowed by IFRS. Parea only pays tax to the Government of Gredonia, at the rate of 22%.

On 1 January 20X6 Parea acquired some plant and equipment for £30,000. In the financial statements it is being written off over its useful life of four years on a straight-line basis, even though tax depreciation is calculated at 27% on a reducing-balance basis.

On 1 January 20X3 Parea acquired a property for £40,000. Both in the financial statements and under tax legislation it is being written off over 25 years on a straight-line basis. On 31 December 20X7 the property was revalued to £50,000 with no change to its useful life, but this revaluation had no effect on the tax base or on tax depreciation.

Requirement

Determine the following amounts for the deferred tax liability of Parea in its consolidated financial statements according to IAS 12, *Income Taxes*.

(1) The deferred tax liability at 31 December 20X6

(2) The deferred tax liability at 31 December 20X7

(3) The charge or credit for deferred tax in profit or loss for the year ended 31 December 20X7

10 XYZ

XYZ, a public limited company, has decided to adopt the provisions of IFRSs for the first time in its financial statements for the year ending 30 November 20X1. The amounts of deferred tax provided as set out in the notes of the group financial statements for the year ending 30 November 20X0 were as follows:

	£m
Tax depreciation in excess of accounting depreciation	38
Other temporary differences	11
Liabilities for healthcare benefits	(12)
Losses available for offset against future taxable profits	(34)
	3

The following notes are relevant to the calculation of the deferred tax liability as at 30 November 20X1:

(1) XYZ acquired a 100% holding in a foreign company on 30 November 20X1. The subsidiary does not plan to pay any dividends for the financial year to 30 November 20X1 or in the foreseeable future. The carrying amount in XYZ's consolidated financial statements of its investment in the subsidiary at 30 November 20X1 is made up as follows:

	£m
Carrying amount of net assets acquired excluding deferred tax	76
Goodwill (before deferred tax and impairment losses)	14
Carrying amount/cost of investment	90

The tax base of the net assets of the subsidiary at acquisition was £60 million. No deduction is available in the subsidiary's tax jurisdiction for the cost of the goodwill.

Immediately after acquisition on 30 November 20X1, XYZ had supplied the subsidiary with inventories amounting to £30 million at a profit of 20% on selling price. The inventories had not been sold by the year end and the tax rate applied to the subsidiary's profit is 25%. There was no significant difference between the fair values and carrying amounts on the acquisition of the subsidiary.

(2) The carrying amount of the property, plant and equipment (excluding that of the subsidiary) is £2,600 million and their tax base is £1,920 million. Tax arising on the revaluation of properties of £140 million, if disposed of at their revalued amounts, is the same at 30 November 20X1 as at the beginning of the year. The revaluation of the properties is included in the carrying amount above.

Other taxable temporary differences (excluding the subsidiary) amount to £90 million as at 30 November 20X1.

(3) The liability for healthcare benefits in the statement of financial position had risen to £100 million as at 30 November 20X1 and the tax base is zero. Healthcare benefits are deductible for tax purposes when payments are made to retirees. No payments were made during the year to 30 November 20X1.

(4) XYZ Group incurred £300 million of tax losses in 20X0. Under the tax law of the country, tax losses can be carried forward for three years only. The taxable profits for the years ending 30 November were anticipated to be as follows:

20X1	**20X2**	**20X3**
£m	**£m**	**£m**
110	100	130

The auditors are unsure about the availability of taxable profits in 20X3, as the amount is based on the projected acquisition of a profitable company. It is anticipated that there will be no future reversals of existing taxable temporary differences until after 30 November 20X3.

(5) Income tax of £165 million on a property disposed of in 20X0 becomes payable on 30 November 20X4 under the deferral relief provisions of the tax laws of the country. There had been no sales or revaluations of property during the year to 30 November 20X1.

(6) Income tax is assumed to be 30% for the foreseeable future in XYZ's jurisdiction and the company wishes to discount any deferred tax liabilities at a rate of 4% if allowed by IAS 12.

(7) There are no other temporary differences other than those set out above. The directors of XYZ have calculated the opening balance of deferred tax using IAS 12 to be £280 million.

Requirement

Calculate the liability for deferred tax required by the XYZ Group at 30 November 20X1 and the deferred tax expense in profit or loss for the year ending 30 November 20X1 using IAS 12, commenting on the effect that the application of IAS 12 will have on the financial statements of the XYZ Group.

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

1.1 The tax base of the accrued expenses is nil.

1.2 The tax base of the interest received in advance is nil.

1.3 The tax base of the prepaid expenses is nil.

1.4 The tax base of the loan is £1 million.

Answer to Interactive question 2

2.1 The tax base of the asset is £70,000 (£100,000 – £30,000).

Recovery through continued use

2.1 Temporary difference of £150,000 – £70,000 = £80,000 is all taxed at 30% resulting in a deferred tax liability of £24,000.

(If the entity expects to recover the carrying amount by using the asset it must generate taxable income of £150,000, but will only be able to deduct depreciation of £70,000.)

2.2 Recovery through sale

2.2 If the entity expects to recover the carrying amount by selling the asset immediately for proceeds of £150,000, the temporary difference is still £80,000. Of this, only the £50,000 excess of proceeds over cost is not taxable. Therefore the deferred tax liability will be computed as follows.

	Taxable temporary difference £	Tax rate	Deferred tax liability £
Cumulative tax depreciation	30,000	30%	9,000
Proceeds in excess of cost	50,000	Nil	–
Total temporary difference	80,000		9,000

Answer to Interactive question 3

3.1 Recovery through continued use

3.1 If the entity expects to recover the carrying amount by using the asset, the situation is as in Recovery 1 above in the same circumstances.

3.2 Recovery through sale

3.2 If the entity expects to recover the carrying amount by selling the asset immediately for proceeds of £150,000, the entity will be able to deduct the indexed cost of £110,000. The net profit of £40,000 will be taxed at 40%. In addition, the cumulative tax depreciation of £30,000 will be included in taxable income and taxed at 30%. On this basis, the tax base is £80,000 (£110,000 – £30,000), there is a taxable temporary difference of £70,000 and there is a deferred tax liability of £25,000 (£40,000 × 40% plus £30,000 × 30%).

Answer to Interactive question 4

Jonquil Co will recover the carrying amount of the equipment by using it to manufacture goods for resale. Therefore, the entity's current tax computation is as follows.

					Year
	20X1	**20X2**	**20X3**	**20X4**	**20X5**
	£	**£**	**£**	**£**	**£**
Taxable income*	10,000	10,000	10,000	10,000	10,000
Depreciation for tax purposes	12,500	12,500	12,500	12,500	0
Taxable profit (tax loss)	(2,500)	(2,500)	(2,500)	(2,500)	10,000
Current tax expense (income) at 40%	(1,000)	(1,000)	(1,000)	(1,000)	4,000

* ie, nil profit plus (£50,000 ÷ 5) depreciation add-back.

The entity recognises a current tax asset at the end of years 20X1 to 20X4 because it recovers the benefit of the tax loss against the taxable profit of year 20X0.

The temporary differences associated with the equipment and the resulting deferred tax asset and liability and deferred tax expense and income are as follows.

					Year
	20X1	**20X2**	**20X3**	**20X4**	**20X5**
	£	**£**	**£**		
Carrying amount	40,000	30,000	20,000	10,000	0
Tax base	37,500	25,000	12,500	0	0
Taxable temporary difference	2,500	5,000	7,500	10,000	0
Opening deferred tax liability	0	1,000	2,000	3,000	4,000
Deferred tax expense (income): bal fig	1,000	1,000	1,000	1,000	(4,000)
Closing deferred tax liability @ 40%	1,000	2,000	3,000	4,000	0

The entity recognises the deferred tax liability in years 20X1 to 20X4 because the reversal of the taxable temporary difference will create taxable income in subsequent years. The entity's income statement is as follows.

					Year
	20X1	**20X2**	**20X3**	**20X4**	**20X5**
	£	**£**	**£**	**£**	**£**
Income	10,000	10,000	10,000	10,000	10,000

	Year				
	20X1	20X2	20X3	20X4	20X5
	£	£	£	£	£
Depreciation	(10,000)	(10,000)	(10,000)	(10,000)	(10,000)
Profit before tax	0	0	0	0	0
Current tax expense (income)	(1,000)	(1,000)	(1,000)	(1,000)	4,000
Deferred tax expense (income)	1,000	1,000	1,000	1,000	(4,000)
Total tax expense (income)	0	0	0	0	0
Net profit for the period	0	0	0	0	0

Answer to Interactive question 5

The company will recognise an expense for the consumption of employee services given in consideration for share options granted, but will not receive a tax deduction until the share options are actually exercised. Therefore a temporary difference arises and IAS 12, *Income Taxes* requires the recognition of deferred tax.

A deferred tax asset (a deductible temporary difference) results from the difference between the tax base of the services received (a tax deduction in future periods) and the carrying value of zero. IAS 12 requires the measurement of the deductible temporary difference to be based on the intrinsic value of the options at the year end. This is the difference between the fair value of the share and the exercise price of the option.

If the amount of the estimated future tax deduction exceeds the amount of the related cumulative remuneration expense, the tax deduction relates not only to the remuneration expense, but also to equity. If this is the case, the excess should be recognised directly in equity.

Year to 31 May 20X6

Deferred tax asset:

	£
Fair value (40,000 × £8.50 × 1/2)	170,000
Exercise price of option (40,000 × £4.00 × 1/2)	(80,000)
Intrinsic value (estimated tax deduction)	90,000
Tax at 30%	27,000

The cumulative remuneration expense is £60,000, which is less than the estimated tax deduction of £90,000. Therefore:

- a deferred tax asset of £27,000 is recognised in the statement of financial position;
- there is deferred tax income of £18,000 (60,000 × 30%); and
- the excess of £9,000 (30,000 × 30%) goes to equity.

Year to 31 May 20X7

Deferred tax asset:

	£
Fair value	

	£
(40,000 × £8)	320,000
(120,000 × £8 × 1/3)	320,000
	640,000
Exercise price of options	
(40,000 × £4)	(160,000)
(120,000 × £5 × 1/3)	(200,000)
Intrinsic value (estimated tax deduction)	280,000
Tax at 30%	84,000
Less previously recognised	(27,000)
	7,000

The cumulative remuneration expense is £220,000, which is less than the estimated tax deduction of £280,000. Therefore:

- a deferred tax asset of £84,000 is recognised in the statement of financial position at 31 May 20X7;
- there is potential deferred tax income of £57,000 for the year ended 31 May 20X7;
- of this, £9,000 (60,000 × 30%) – (9,000) goes directly to equity; and
- the remainder (£48,000) is recognised in profit or loss for the year.

Answer to Interactive question 6

The entity recognises a deferred tax asset of £0.9 million (£3m × 30%) and, in profit or loss, deferred tax income of £0.9 million. Goodwill is not adjusted, as the recognition does not arise within the measurement period (ie, within the 12 months following the acquisition).

Answer to Interactive question 7

7.1 The fair value adjustment to the property reduces goodwill by £24 million (being 80% of the £30m FV adjustment).

As a result of the fair value uplift, the non-controlling interest must be adjusted up by £6 million (20% × £30m).

The journal to record the adjustments to property, goodwill and the NCI at the date of acquisition is:

DEBIT	Property	£30m	
CREDIT	Goodwill		£24m
CREDIT	NCI		£6m

The fair value uplift is subsequently depreciated such that by the reporting date its carrying value is £15 million (10/20 yrs × £30m). The journal to record the consolidation adjustment for extra depreciation is:

DEBIT	Group retained earnings (80% × £15m)	£12m	
DEBIT	NCI (20% × 15,000)	£3m	
CREDIT	Property – accumulated depreciation		£15m

7.2 At acquisition, property held within Dorian's accounts is uplifted by £30 million as a consolidation adjustment.

This results in a taxable temporary difference of £30 million, and so a deferred tax liability of £4.8 million (16% × £30m) at acquisition.

This is recognised by:

DEBIT	Goodwill	£3.84m	
DEBIT	Non-controlling interest (20% × £4.8m)	£0.96m	
CREDIT	Deferred tax liability		£4.8m

By the reporting date, £15 million of this temporary difference has reversed and therefore a further journal is required to reduce the deferred tax liability by £2.4 million (16% × £15m):

DEBIT	Deferred tax liability	£2.4m	
CREDIT	Retained earnings (80% × £2.4m)		£1.92m
CREDIT	NCI (20% × £2.4m)		£0.48m

Answer to Interactive question 8

An intangible asset acquired in a business combination is recognised where it meets the definition of an asset and is identifiable ie, it is either separable or arises from contractual or legal rights. This is the case regardless of whether the acquiree recognises the asset on its individual statement of financial position.

The Jenner Group amortises domain names over a 10-year (120 month) period. Rannon was acquired 50 months before the reporting date, therefore the carrying amount of the domain name as at 31 March 20X4 is 70/120 × £40,800,000 = £23,800,000.

A deferred tax liability arises in respect of the fair value adjustment since this results in the carrying amount of the domain name exceeding its tax base of nil. The deferred tax liability is 17% × £23,800,000 = £4,046,000.

Amortisation since acquisition of 50/120 × £40,800,000 = £17,000,000 on the domain name and the £2,890,000 (£17,000,000 × 17%) movement in the associated deferred tax liability must also be accounted for and allocated between group retained earnings and the non-controlling interest:

(1)

DEBIT	Intangible assets	£40,800,000	
CREDIT	Goodwill		£40,800,000

To recognise fair value adjustment on acquisition.

DEBIT	Retained earnings (60% × 17% × £40,800,000)	£4,161,600	
DEBIT	Non-controlling interest (40% × 17% × £40,800,000)	£2,774,400	
CREDIT	Deferred tax liability		£6,936,000

To recognise deferred tax liability on fair value adjustment at acquisition.

(2)

DEBIT	Retained earnings (60% × £17,000,000)	£10,200,000	
DEBIT	Non-controlling interest (40% × £17,000,000)	£6,800,000	
CREDIT	Intangible assets		£17,000,000

To recognise amortisation on the domain name since acquisition.

(3)

DEBIT	Deferred tax liability	£2,890,000	
CREDIT	Retained earnings (60% × £2,890,000)		£1,734,000
CREDIT	Non-controlling interest (40% × £2,890,000)		£1,156,000

To recognise the movement in deferred tax on the fair value adjustment since acquisition.

Answer to Interactive question 9

(1) An unrelieved tax loss gives rise to a deferred tax asset; however, only where there are expected to be sufficient future taxable profits to use the loss.

There is no indication of Rhydding's future profitability, although the extent of the current year losses suggests that future profits may not be available. If this is the case then no deferred tax asset should be recognised.

If, however, the current year loss is due to a one-off factor, or there are other reasons why a return to profitability is expected, then the deferred tax asset may be recognised at 20% × £6.5m = £1.3 million.

(2) The intra-group sale gives rise to an unrealised year-end profit of £12m × 20/120 × ½ = £1m. Consolidated profit and inventory are adjusted for this amount.

This profit has, however, already been taxed in the accounts of Burley. A deductible temporary difference therefore arises which will reverse when the goods are sold outside the group and the profit is realised. The resulting deferred tax asset is £1m × 30% = £300,000.

This may be recognised to the extent that it is recoverable.

Answer to Interactive question 10

(1)

(a) Fair value adjustments are treated in a similar way to temporary differences on revaluations in the entity's own accounts. A deferred tax liability is recognised under IAS 12 even though the directors have no intention of selling the property, as it will generate taxable income in excess of depreciation allowed for tax purposes. The deferred tax of £1m × 25% = £0.25m is debited to goodwill, reducing the fair value adjustments (and net assets at acquisition) and increasing goodwill.

(b) Provisions for unrealised profits are temporary differences which create deferred tax assets and the deferred tax is provided at the receiving company's rate of tax. A deferred tax asset would

IMAGE GOES HERE

(2)

(a) The unrealised gains are temporary differences which will reverse when the investments are sold therefore a deferred tax liability needs to be created of (£8m × 25%) = £2m.

(b) The allowance is a temporary difference which will reverse when the currently unidentified loans go bad and the entity will then be entitled to tax relief. A deferred tax asset of (£2m at 25%) = £500,000 should be created.

(3) No deferred tax liability is required for the additional tax payable of £2 million, as Angelo controls the dividend policy of Escalus and does not intend to remit the earnings to its own tax regime in the foreseeable future.

(4) Angelo's unrelieved trading losses can only be recognised as a deferred tax asset to the extent they are considered to be recoverable. In assessing the recoverability there needs to be evidence that there will be suitable taxable profits from which the losses can be deducted in the future. To the extent Angelo itself has a deferred tax liability for future taxable trading profits (eg, accelerated tax depreciation) then an asset could be recognised.

Answer to Interactive question 11

Investments in foreign branches (or subsidiaries, associates or joint arrangements) are affected by **changes in foreign exchange rates**. In this case, the branch's taxable profits are determined in dinars, and changes in the dinar/pound exchange rate may give rise to temporary differences. These differences can arise where the carrying amounts of the non-monetary assets are translated at historical rates and the tax base of those assets are translated at the closing rate. The **closing rate** may be used to translate the tax base because the resulting figure is an **accurate measure of the**

amount that will be deductible in future periods. The deferred tax is charged or credited to profit or loss.

The deferred tax arising will be calculated **using the tax rate in the foreign branch's jurisdiction**, that is **20%.**

Property	**Dinars ('000)**	**Exchange rate**	**Pounds £'000**
Carrying amount:			
Cost	6,000		1,200
Depreciation for the year	(500)		(100)
Carrying amount	5,500	5	1,100
Tax base:			
Cost	6,000		
Tax depreciation	(750)		
Carrying amount	5,250	6	875
Temporary difference			225
Deferred tax at 20%			45

The **deferred tax charge in profit or loss will therefore increase by £45,000.**

If the tax base had been translated at the historical rate, the tax base would have been £(5.25m ÷ 5) = £1.05 million. This gives a temporary difference of £1.1m – £1.05m = £50,000, and therefore a deferred tax liability of £50,000 × 20% = £10,000. This is considerably lower than when the closing rate is used.

Answer to Interactive question 12

According to IAS 12, *Income Taxes* the tax expense in the statement of profit or loss and other comprehensive income includes the tax charge for the year, any under or overprovision of income tax from the previous year and any increase or decrease in the deferred tax provision:

	£
Current tax expense	X
Under/overprovisions relating to prior periods	X/(X)
Increases/decreases in the deferred tax balance	X/(X)
	X

While the correction of an over or under provision relates to a prior period, this is **not a prior period adjustment** as defined in IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors* and as assumed by Tacks. Rather, it is a **change in accounting estimate**.

Changes in accounting estimates result from new information or new developments and, accordingly, are **not corrections of errors**. A prior period error, which would require a prior period adjustment is **an omission or misstatement arising from failure to use reliable information** that was available or could have been obtained at the time of the authorisation of the financial statements. This is **not the case here**. Tacks had accounted for all known issues at the previous year end (30 November 20X1), and could not have foreseen that the tax adjustment would be required. No penalties were applied by the taxation authorities, indicating that there were no fundamental errors in the information provided to them. Correction of an over- or under-provision for taxation is routine, since taxation liabilities are difficult to estimate.

The effect of a change in accounting estimate must be **applied by the company prospectively** by including it in profit or loss in the period of change, with separate disclosure of the adjustment in the financial statements.

Answer to Interactive question 13

Journal entries and explanations:

Machinery purchase

The plant is categorised as a non-monetary asset per IAS 21. As such it should be measured at the rate of exchange at the acquisition date of 1 January 20X3. Therefore the plant should originally have been included at cost of Kr12 million (US$30m/2.5) and a liability for that sum recognised too.

Depreciation should be charged over the useful life of the asset, which commences on 1 January, and so only nine months depreciation is required to 30 September 20X3. This gives a depreciation charge of Kr900,000 and a carrying amount of Kr11.1 million.

An exchange difference arises between 1 January and 31 March, when payment is made. This should be charged to the income statement instead of directly to equity.

The correct exchange difference is therefore a loss of Kr500,000 (Kr12.5m – Kr12m).

The relevant correcting journals are:

		Dr	Cr
		Kr million	**Kr million**
DEBIT	PPE		
	Cost Kr12m – Kr10m	2	
CREDIT	Creditor		2
Being correct recording of cost of the machinery			
DEBIT	Creditor	2.5	
CREDIT	Retained earnings		2.5
Being journal to reverse original exchange difference (Kr12.5m – Kr10m)			
DEBIT	Profit or loss	0.5	
CREDIT	Creditor		0.5
Being correct exchange loss taken to profit or loss			
DEBIT	PPE	0.1	
CREDIT	Profit or loss		0.1
Being correction to depreciation charge (Kr1m – Kr0.9m)			

There are no deferred tax implications as the tax base and the carrying amount are the same.

Impairment

Per IAS 36 the impairment of Kr18 million should initially be offset against the revaluation surplus of Kr16.8 million, and the excess of Kr1.2 million charged in the income statement.

The journal is:

CREDIT	Profit or loss	Kr16.8m	
DEBIT	Revaluation surplus		Kr16.8m

Again there should be no deferred tax implications as the tax base and the carrying amount are the same.

Investment

The investment is classified as held for trading per IFRS because there is an intention to sell the shares at the end of the year. Therefore they should be measured at fair value and the gain/loss taken to the income statement.

At 30 September the increase in fair value is Kr4.8 million, and this is credited to the income statement.

DEBIT	Investments	Kr4.8m	
CREDIT	Profit or loss		Kr4.8m

A deferred tax liability of Kr 960,000 (20% × Kr 4.8m) should be created because the recognition of the increase in fair value represents a taxable temporary difference.

DEBIT	Profit or loss deferred tax	Kr960,000	
CREDIT	Deferred tax provision		Kr960,000

Provision

The provision should initially be based on a figure of Kr10 million per IAS 37, as this is the most likely outcome for the clean-up costs.

However the provision should then be discounted using the pre-tax discount rate of 8% over the 20-year period from 1 October 20X2. The initial provision should therefore be Kr2.145 million.

As the provision relates to the rights, the cost should be added to intangible assets.

The intangible asset should then be amortised in the income statement over the 20 years to when the rights expire.

The provision should be unwound over the period to when the clean-up costs are due.

		Dr	Cr
		Kr million	**Kr million**
DEBIT	Intangible asset	2.145	
DEBIT	Provision	12.855	
CREDIT	Profit or loss		15
DEBIT	Profit or loss (Kr10.645m/20)	0.532	
CREDIT	Intangible asset		0.532
DEBIT	Profit or loss (finance costs) (Kr2.145m × 8%)	0.172	
CREDIT	Provision		0.172

Because the clean-up costs are tax deductible, a deferred tax asset should be created for the provision at 30 September 20X3.

The provision is Kr2.317 million (Kr2.145m + 0.172m) and so the deferred tax asset is Kr0.463 million.

		Dr	Cr
		Kr million	**Kr million**
DEBIT	Deferred tax asset	0.463	
CREDIT	Profit or loss		0.463

Adjusted statement of financial position

Statement of financial position at 30 September 20X3

	Draft	Plant	Impair	Invest	Prov'n	Total
	Kr'000	Kr'000		Kr'000		Kr'000
Non-current assets						
Property, plant & equipment	61,600	2,100				63,700
Intangible assets	8,500				1,613	10,113
Financial investments	7,700			4,800		12,500
Deferred tax	0				463	463
	77,800					86,776
Current assets	23,700					23,700
Total assets	101,500					110,476
Equity and liabilities						
Capital and reserves						
Issued Kr 1 shares	10,000					10,000
Retained earnings	42,600	2,100	16,800	3,840	14,759	80,099
Revaluation surplus	16,800		(16,800)			0
	69,400					90,099
Non-current liabilities						
Loans	10,000					10,000
Provisions	15,000				(12,683)	2,317
Deferred tax	0			960		960
Current liabilities						

Statement of financial position at 30 September 20X3

	Draft	Plant	Impair	Invest	Prov'n	Total
	Kr'000	Kr'000		Kr'000		Kr'000
	7,100					7,100
Total equity & liabilities	101,500					110,476

Note: The deferred tax asset can be offset against the deferred tax liability if both are due to the same tax authority.

Impairment loss: Gemex

The impairment loss in the financial statements of Gemex **reduces the carrying value** of property, plant and equipment, but is **not allowable for tax**. Therefore the **tax base** of the property, plant and equipment **is different from its carrying value** and there is a **temporary difference**.

Under IAS 36, *Impairment of Assets* the impairment loss is allocated first to goodwill and then to other assets:

	Goodwill	Property, plant and equipment	Total
	£m	£m	£m
Carrying value at 30 September 20X3	1	6.0	7.0
Impairment loss	(1)	(0.8)	(1.8)
	–	5.2	5.2

IAS 12 states that **no deferred tax should be recognised on goodwill** and therefore **only the impairment loss relating to the property, plant and equipment affects the deferred tax position.**

The effect of the impairment loss is as follows:

	Before impairment	After impairment	Difference
	£m	£m	£m
Carrying value	6	5.2	
Tax base	(4)	(4.0)	
Temporary difference	2	1.2	0.8
Tax liability (20%)	0.4	0.24	0.16

Therefore the impairment loss reduces the deferred tax liability by £160,000.

Answers to Self-test questions

1 Torcularis

£nil and £80,000

IAS 12.7 Examples 2 and 3 show that:

- For interest receivables the tax base is nil.
- The tax base for trade receivables is equal to their carrying amount.

2

(1) Deferred tax liability

(2) Deferred tax asset

(3) No deferred tax implications

'Development costs' lead to a deferred tax liability.

'A penalty payable' has no deferred tax implications.

3 Budapest

(1) True

(2) True

Under IAS 12.19 the excess of an asset's fair value over its tax base at the time of a business combination results in a deferred tax liability. As it arises in Lisbon, the tax rate used is 20% and the liability is £800 ((£12,000 – £8,000) × 20%).

The recognition of a deferred tax liability in relation to the initial recognition of goodwill is specifically prohibited by IAS 12.15(a).

4 Dipyrone

£25,250

Under IFRS 10, intra-group profits recognised in inventory are eliminated in full and IAS 12 applied to any temporary differences that result. This profit elimination results in the tax base being higher than the carrying amount, so deductible temporary differences arise. Deferred tax assets are measured by reference to the tax rate applying to the entity who currently owns the inventory.

So the deferred tax asset in respect of Dipyrone's eliminated profit is £14,850 (£600,000 × 25% × 30% × 33% tax rate) and in respect of Reidfurd's eliminated profit is £10,400 (£800,000 × 20% × 25% × 26% tax rate), giving a total of £25,250.

5 Rhenium

£30,000 asset

The year-end accrual is £120,000 (£6m × 8% × 3/12). Because the £120,000 year-end carrying amount of the accrued interest exceeds its nil tax base, under IAS 12.5 there is a deductible temporary difference, of £120,000. Under IAS 12.24 a deferred tax asset must be recognised.

The deferred tax asset is the deductible temporary difference multiplied by the tax rate expected to exist when the tax asset is realised (IAS 12.47). This gives a deferred tax asset of (£120,000 × 25%) = £30,000.

6 Cacholate

£162,000

Because the £2.16 million year-end carrying amount of the asset exceeds its £1.35 million (£1,500,000 × 18/20) tax base, under IAS 12.5 there is a taxable temporary difference, of £810,000. Under IAS 12.15 a deferred tax liability must be recognised, of £162,000 (£810,000 × 20%). As there was no such liability last year (the carrying amount and the tax base were the same), the charge in the current year is for the amount of the liability.

Because the revaluation surplus is recognised as other comprehensive income and accumulated in equity (*IAS 12.62*), the deferred tax charge is recognised as tax on other comprehensive income and also accumulated in equity, under IAS 12.61.

7 Spruce

£550,000

A deferred tax asset shall be recognised for the carry forward of unused tax losses to the extent that future taxable profits will be available for offset (*IAS 12.34*). The loss incurred in the current year is a one-off, and the company has a history of making profits and expects to do so over the next two years. So it is likely that there will be future profits to offset.

£500,000 of the loss will be relieved by carry back, leaving £4,200,000 for carry forward. But the carry forward is limited to the likely future profits, so £2.2 million.

At the 25% tax rate, the deferred tax asset is £550,000.

8 Bananaquit

(1) False

(2) False

The deferred tax figure in profit or loss is the difference between the opening and closing deferred tax liabilities. At the start of the year the liability was £450,000 (£1.5m × 30%). The amount of the change is £30,000, but it is a deferred tax credit, not charge to profit or loss.

At the end of the year the £2.4 million carrying amount of the assets exceeds their £1.0 million tax base, so under IAS 12.5 there is a taxable temporary difference, of £1.4 million. Under IAS 12.15 a deferred tax liability (not asset) of £420,000 (£1.4m × 30%) must be recognised.

9 Antpitta

(1) False

(2) True

There is an unrealised profit relating to inventories still held within the group, which must be eliminated on consolidation *(IFRS 10*). But the tax base of the inventories is unchanged, so it is higher than the carrying amount in the consolidated statement of financial position and there is a deductible temporary difference (*IAS 12.5*).

10 Parea

(1) £132

(2) £3,743

(3) £349 credit

At 31 December 20X6 the carrying amount of the plant is £30,000 × (1 – 25%) = £22,500, while the tax base is £30,000 × (1 – 27%) = £21,900. The taxable temporary difference is £600 and the deferred tax liability is 22% thereof, £132.

At 31 December 20X7 the carrying amount of the plant is £30,000 × (1 – (25% × 2)) = £15,000, while the tax base is £30,000 × $(1 - 27\%)^2$ = £15,987, leading to a deductible temporary difference of £987. A deferred tax asset should be recognised in relation to this.

Before its revaluation, the property's carrying amount is £40,000 – (5 years at 4%) = £32,000 and the tax base is the same. The revaluation to £50,000 creates a taxable temporary difference of £18,000.

As Parea pays all its tax to a single authority, it must offset deferred tax assets and liabilities (IAS 12.74). At 31 December 20X7 there is a deferred tax liability of £(–987 + 18,000) = £17,013 × 22% = £3,743.

The change in deferred tax liability over the year is £3,743 – £132 = £3,611. Of this, £18,000 × 22% = £3,960 relates to the property revaluation and is recognised in other comprehensive income. This leaves £3,611 – £3,960 = £(349) to be credited to profit or loss (IAS 12.58).

11 XYZ

	Carrying amount £m	Tax base £m	Temporary differences £m	Rate %	XYZA/(XYZA) £m
Goodwill (Note 1)	14	–	–		
Subsidiary (Note 1)	76	60	16	25	4
Inventories (Note 2)	24	30	(6)	25	(1.5)
Property, plant and equipment (Note 3)	2,600	1,920	680	30	204
Other temporary differences			90	30	27
Liability for healthcare benefits	(100)	0	(100)	30	(30)
Unrelieved tax losses (Note 4)			(100)	30	(30)
Property sold – tax due 30.11.20X4 (165/30%)			550	30	165
			1,130		338.5 *
Deferred tax liability b/d (given)			280		
Deferred tax attributable to subsidiary to goodwill (from above)			4		
∴ Deferred tax expense for the year charged to P/L (balance)			54.5		
Deferred tax liability c/d (from above)			338.5 *		
*Deferred tax asset (1.5 + 30 + 30)			(61.5)		
Deferred tax liability (balance)			400		
			338.5		

Notes

(1) As no deduction is available for the cost of goodwill in the subsidiary's tax jurisdiction, then the tax base of goodwill is zero. Paragraph 15(a) of IAS 12 states that XYZ Group should not recognise a deferred tax liability of the temporary difference associated with the goodwill. Goodwill will be increased by the amount of the deferred tax liability of the subsidiary ie, £4 million.

(2) Unrealised group profit eliminated on consolidation is provided for at the receiving company's rate of tax (ie, at 25%).

(3) The tax that would arise if the properties were disposed of at their revalued amounts which was provided at the beginning of the year will be included in the temporary difference arising on the property, plant and equipment at 30 November 20X1.

(4) XYZ Group has unrelieved tax losses of £300 million. This will be available for offset against current year's profits (£110m) and against profits for the year ending 30 November 20X2 (£100m). Because of the uncertainty about the availability of taxable profits in 20X3, no deferred

tax asset can be recognised for any losses which may be offset against this amount. Therefore, a deferred tax asset may be recognised for the losses to be offset against taxable profits in 20X2. That is £100 million × 30% ie, £30 million.

Comment

The deferred tax liability of XYZ Group will rise in total by £335.5 million (£338.5m – £3m), thus reducing net assets, distributable profits and post-tax earnings. The profit for the year will be reduced by £54.5 million which would probably be substantially more under IAS 12 than the old method of accounting for deferred tax. A prior period adjustment will occur of £280m – £3m as IAS are being applied for the first time (IFRS 1) ie, £277 million. The borrowing position of the company may be affected and the directors may decide to cut dividend payments. However, the amount of any unprovided deferred tax may have been disclosed under the previous GAAP standard used. IAS 12 brings this liability into the statement of financial position but if the bulk of the liability had already been disclosed the impact on the share price should be minimal.

Appendix

Tax Tables FA2020

Syllabus area: Administration

SUBMISSION DATES

Submission dates for 2020/21 personal self-assessment tax returns

Return filed online	Later of: 31 January 2022 3 months from the date of issue of return
Paper returns	Later of: 31 October 2021 3 months from the date of issue of return

Submission dates for corporation tax returns

Must be filed by 12 months from the end of the period of account.

Submission dates for PAYE information: Real Time Information

Information	**Filing date**
Full Payment Submission (FPS)	On or before the day the employee is paid
P60 (to employees)	31 May following the tax year end
P11D	6 July following the tax year end

PAYMENT DATES

Payment dates for income tax

Payment	**Filing date**
First interim payment (1)	31 January in the tax year
Second interim payment (1)	31 July following the tax year end
Balancing payment	31 January following the tax year end

(1) Interim payments are not required if the tax paid by assessment for the previous year was less than:

£1,000; or

20% of the total tax liability (income tax and Class 4)

Payment dates for capital gains tax

Capital gains tax is payable by 31 January following the tax year end.

Payment dates for corporation tax	
Corporation tax	Nine months and one day after the end of an accounting period
Corporation tax by instalments – large companies	The 14th day of months 7, 10, 13 and 16 counted from the start of a 12-month accounting period
Corporation tax by instalments – very large companies	The 14th day of months 3, 6, 9 and 12 counted from the start of a 12-month accounting period

Payment dates for VAT

	Due date
Electronic payment	7 calendar days after the last day of the month following the end of the return period
Direct debit payment	Collected automatically 3 working days after electronic payment due date

MAIN PENALTY PROVISIONS

PENALTIES FOR INCORRECT RETURNS

The penalties are a percentage of the potential lost revenue

Reason for penalty	Maximum penalty	Minimum penalty with unprompted disclosure	Minimum penalty with prompted disclosure
Careless action	30%	Nil	15%
Deliberate but not concealed action	70%	20%	35%
Deliberate and concealed action	100%	30%	50%

PENALTIES FOR FAILURE TO NOTIFY

Failures to notify chargeability to tax, or liability to register for tax that leads to a loss of tax will result in a penalty. The penalties are a percentage of the potential lost revenue.

Reason for penalty	Maximum penalty	Minimum penalty with unprompted disclosure		Minimum penalty with prompted disclosure	
Deliberate and concealed action	100%		30%		50%
Deliberate but not concealed action	70%		20%		35%
		>12m	<12m	>12m	<12m
Any other case	30%	10%	Nil	20%	10%

COMPANIES: PENALTIES

Offence	Maximum Penalty
Failure to notify chargeability within 12 months of end of accounting period	See above: penalties for failure to notify

Corporation tax: penalties for late filing of a corporation tax return

Offence	Penalty[(1)]
Late return, up to 3 months late	£100 fixed penalty, or £500 for persistent failure
Return more than 3 months late	£200 fixed penalty, or £1,000 for persistent failure
Return filed more than 18 months but less than 24 months after end of return period	Tax geared penalty of 10% of tax unpaid 18 months after end of return period
Return filed more than 24 months after end of return period	Tax geared penalty of 20% of tax unpaid 18 months after end of return period

(1) The tax geared penalty is charged in addition to the fixed penalty but only one of each type of penalty is charged.

INDIVIDUALS: PENALTIES

Offence	Maximum Penalty
Failure to notify chargeability by 5 October following tax year end	See above: penalties for failure to notify
Late payment of income tax or capital gains tax: [(1)]	
Unpaid 30 days after payment due date	5% of tax unpaid
Unpaid 6 months after payment due date	Further 5% of tax unpaid
Unpaid 12 months after payment due date	Further 5% of tax unpaid

(1) Late payment penalties do not apply to payments on account.

Income tax and CGT: penalties for late filing of a self-assessment return

Offence	Maximum Penalty
Late return	Immediate £100 fixed penalty
Return more than 3 months late	Daily fixed penalties of up to £10 per day for maximum 90 days
Return more than 6 months but less than 12 months late	Further tax geared penalty of 5% of tax due (minimum £300)
Return 12 months late	Further tax geared penalties apply (minimum £300): 100% if deliberate and concealed[(1)] 70% if deliberate but not concealed[(1)] 5% in all other cases

(1) These tax geared penalties are reduced for disclosure as per penalties for incorrect returns.

PAYE: penalties for late returns/ submissions

Number of employees	Monthly penalty
1 to 9	£100
10 to 49	£200
50 to 249	£300
250 or more	£400

If the form is more than three months late, an additional penalty is due of 5% of the tax and NIC that should have been reported.

Additionally, there is a £300 penalty per late P11D return, with an extra £60 per day charged if the delay continues.

PAYE: penalties for late payment

	No of late payments	% of tax unpaid[(1)]
	1st	nil
	2nd, 3rd & 4th	1%
	5th, 6th & 7th	2%
	8th, 9th & 10th	3%
Penalties for late payment of in-year PAYE depend on the number of defaults in the tax year	11th or more	4%
Where a penalty has been imposed and the tax remains unpaid at 6 months		5%[(2)]
Where a penalty has been imposed and the tax		5%[(2)]

remains unpaid at 12 months

(1) The percentage penalty is applied to the total amount that is late in the relevant tax month.

(2) The 6 month and the further 12 month penalties are in addition to the initial penalty for late payment.

VAT: penalties

Offence	Maximum Penalty
Failure to notify liability for registration or change in nature of supplies by person exempted from registration	See above: penalties for failure to notify

VAT: late payment or late filing – default surcharge

Default involving late payment of VAT in the surcharge period[1]	Surcharge as a percentage of the VAT outstanding at the due date
First	2%[2]
Second	5%[2]
Third	10%[3]
Fourth	15%[3]

(1) Default if late payment of VAT or filing of VAT return and surcharge liability notice issued, but default surcharge only applies on late payment.

(2) No surcharge if it would be less than £400.

(3) Minimum £30 payable.

VAT errors

An error made on a VAT return can be corrected on the next return provided it was not deliberate and does not exceed the greater of:

- £10,000 (net under-declaration minus over-declaration); or
- 1% x net VAT turnover for return period (maximum £50,000)

Alternatively, a 'small' error which is not deliberate may be corrected via the submission of form VAT652. Errors which are not 'small' or errors which are deliberate should be notified to HMRC on form VAT652.

RECORD KEEPING PENALTY

Offence	Maximum Penalty
Failure to keep and retain tax records	£3,000 per tax year / accounting period

INCOME TAX RATES: 2020/21

	Rate	Taxable income band
Main rates		
Basic rate	20%	£1 – £37,500
Higher rate	40%	£37,501 – £150,000
Additional rate	45%	Over £150,000
Savings rates		
Starting rate for savings	0%	£1 - £5,000
Savings income nil rate	0%	First £1,000 or £500
Savings basic rate	20%	Otherwise chargeable at basic rate

	Rate	Taxable income band
Savings higher rate	40%	Otherwise chargeable at higher rate
Savings additional rate	45%	Otherwise chargeable at additional rate
Dividends rates		
Dividend nil rate	0%	First £2,000
Dividend ordinary rate	7.5%	Otherwise chargeable at basic rate
Dividend upper rate	32.5%	Otherwise chargeable at higher rate
Dividend additional rate	38.1%	Otherwise chargeable at additional rate
Default rates		
Default basic rate	20%	
Default higher rate	40%	
Default additional rate	45%	

INCOME TAX RELIEFS	2020/21
Personal allowance	£12,500

CGT RATES

	2020/21
Gains falling within the remaining basic rate band	10%
Gains exceeding the basic rate band	20%

CORPORATION TAX RATES

	FY 2020
Tax rate	19%
Augmented profits limit for corporation tax payment dates – large companies	£1,500,000
Augmented profits limit for corporation tax payment dates – very large companies	£20,000,000

NATIONAL INSURANCE CONTRIBUTIONS

	2020/21		
NIC CLASS 1	**Annual**	**Monthly**	**Weekly**
Primary threshold (PT)	£9,500	£792	£183
Secondary threshold (ST)	£8,788	£732	£169
Upper earnings limit (UEL)	£50,000	£4,167	£962
Apprentice upper secondary threshold (AUST) for under 25s	£50,000	£4,167	£962
Upper secondary threshold (UST) for under 21s	£50,000	£4,167	£962

NIC CLASS 1		2020/21 Annual	Monthly	Weekly
Employment allowance (per year, per employer)	£4,000			
Class 1 Primary contributions on earnings between PT & UEL	12%			
Class 1 Primary contributions on earnings above UEL	2%			
Class 1 Secondary contributions on earnings above ST where employee aged 21 or over and not an apprentice under the age of 25	13.8%			
Class 1 Secondary contributions on earnings between ST & AUST for apprentices under the age of 25	0%			
Class 1 Secondary contributions on earnings above AUST for apprentices under the age of 25	13.8%			
Class 1 Secondary contributions on earnings between ST & UST for employees under the age of 21	0%			
Class 1 Secondary contributions on earnings above UST for employees under the age of 21	13.8%			
Class 1A contributions	13.8%			

	2020/21
NIC CLASS 2	
Normal rate	£3.05 pw
Small profits threshold	£6,475 pa
NIC CLASS 4	
Annual lower profits limit (LPL)	£9,500
Annual upper profits limit (UPL)	£50,000
Percentage rate between LPL & UPL	9%
Percentage rate above UPL	2%

VAT	
Standard rate of VAT	20%
Reduced rate of VAT	5%

Syllabus Area: Income Tax & NIC

INCOME TAX RATES: 2020/21	Rate	Taxable income band
Main rates		
Basic rate	20%	£1 – £37,500
Higher rate	40%	£37,501 – £150,000
Additional rate	45%	Over £150,000
Savings rates		

INCOME TAX RATES: 2020/21	Rate	Taxable income band
Starting rate for savings	0%	£1 - £5,000
Savings income nil rate	0%	First £1,000 or £500
Savings basic rate	20%	Otherwise chargeable at basic rate
Savings higher rate	40%	Otherwise chargeable at higher rate
Savings additional rate	45%	Otherwise chargeable at additional rate
Dividends rates		
Dividend nil rate	0%	First £2,000
Dividend ordinary rate	7.5%	Otherwise chargeable at basic rate
Dividend upper rate	32.5%	Otherwise chargeable at higher rate
Dividend additional rate	38.1%	Otherwise chargeable at additional rate
Default rates		
Default basic rate	20%	
Default higher rate	40%	
Default additional rate	45%	

INCOME TAX RELIEFS	2020/21
Personal allowance(1)	£12,500
Marriage allowance(2)	£1,250

(1) The personal allowance of any individual with adjusted net income above £100,000 is reduced by £1 for every £2 of adjusted net income above the £100,000 limit.

(2) A spouse or civil partner who is a basic rate taxpayer or who has income of less than the personal allowance is allowed to transfer £1,250 of their personal allowance (ie 10% rounded up to the next £10) to their spouse/civil partner provided the recipient spouse is a basic rate taxpayer.

CAPITAL ALLOWANCES

First year allowances available

100% on new and unused zero emissions goods vehicles

100% on new and unused low emission cars ie electrically propelled or with CO_2 emissions of not more than 50 g/km

100% on electric vehicle charging points

Annual investment allowance

£200,000 pa of expenditure incurred by any business on certain plant and machinery from 1 January 2021.

Writing down allowances

18% pa in the main pool

COMPANY VANS, CARS AND FUEL

Van scale charge

No charge applies if there is insignificant private use

£2,792 if van has zero CO_2 emissions and £3,490 if it has CO_2 emissions

Additional £666 if private fuel provided for the van

Company cars – cash equivalent	
Zero emissions cars	0% of list price

Company cars – cash equivalent

Hybrid cars with emissions 1-50g/km	2% of list price for cars with a battery range of >130 miles
	5% of list price for cars with a battery range of 70-129 miles
	8% of list price for cars with a battery range of 40-69 miles
	12% of list price for cars with a battery range of 30-39 miles
	14% of list price for cars with a battery range of <30 miles
Other cars	15% of list price for cars emitting 51-54g/km
	16% of list price for cars emitting 55-59g/km
	17% of list price for cars emitting 60-64g/km
	18% of list price for cars emitting 65-69g/km
	19% of list price for cars emitting 70-74g/km
	20% of list price for cars emitting 75-79g/km
	Increased by 1% per 5g/km over the 75g/km relevant threshold

Relevant % is reduced by 2% for cars first registered from 6 April 2020

Capped at 37% of list price (ie emissions of 160g/km or more for cars first registered before 6 April 2020 and 170g/km for cars first registered from 6 April 2020)

Diesel cars that meet the Real Driving Emissions Step 2 (RDE2) standard are treated as above, all other diesel cars have a 4% supplement added to the relevant percentage (subject to 37% cap)

Private fuel provided for company car

£24,500 x company car %

PAYE CODES

L	tax code with personal allowance
M	tax code with personal allowance plus claiming marriage allowance
N	tax code with personal allowance less surrendered marriage allowance
S	income taxed at Scottish rate of income tax
C	income taxed at Welsh rate of income tax
K	total allowances are less than total deductions
T	tax code includes other calculations to work the personal allowance, for example it has been reduced because estimated annual income is more than £100,000

NATIONAL INSURANCE CONTRIBUTIONS

	2020/21		
NIC CLASS 1 CONTRIBUTIONS	**Annual**	**Monthly**	**Weekly**
Primary threshold (PT)	£9,500	£792	£183
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Class 1 Secondary contributions on earnings above UST for employees under the age of 21	13.8%			
Class 1A contributions	13.8%			

	2020/21
NIC CLASS 2 CONTRIBUTIONS	
Normal rate	£3.05 pw
Small profits threshold	£6,475 pa
NIC CLASS 4 CONTRIBUTIONS	
Annual lower profits limit (LPL)	£9,500
Annual upper profits limit (UPL)	£50,000
Percentage rate between LPL & UPL	9%
Percentage rate above UPL	2%

Syllabus area: Capital Gains

	2020/21
Annual exempt amount	£12,300
Gains falling within the remaining basic rate band	10%
Gains exceeding the basic rate band	20%
Basic rate band	£1 – £37,500

Syllabus area: Corporation tax

	FY 2020
Tax rate	19%
Augmented profits limit for corporation tax payment dates – large companies	£1,500,000
Augmented profits limit for corporation tax payment dates – very large companies	£20,000,000

CAPITAL ALLOWANCES

First year allowances available

100% on new and unused zero emissions goods vehicles

100% on new and unused low emission cars ie electrically propelled or with CO_2 emissions of not more than 50 g/km

100% on electric vehicle charging points

Annual investment allowance

£200,000 pa of expenditure incurred by any business on certain plant and machinery from 1 January 2021.

Writing down allowances

18% pa in the main pool

PAYMENT DATES

Payment dates for corporation tax	
Corporation tax	Nine months and one day after the end of an accounting period
Corporation tax by instalments – large companies	The 14th day of months 7, 10, 13 and 16 counted from the start of a 12-month accounting period
Corporation tax by instalments – very large companies	The 14th day of months 3, 6, 9 and 12 counted from the start of a 12-month accounting period

Syllabus area: Value Added Tax

VAT		
Standard rate		20%
Reduced rate		5%
Annual registration limit	From 1 April 2017	£85,000
Deregistration limit	From 1 April 2017	£83,000
VAT fraction (standard rated)		1/6

Cash accounting	**£**
Turnover threshold to join scheme	1,350,000
Turnover threshold to leave scheme	1,600,000
Annual accounting	
Turnover threshold to join scheme	1,350,000
Turnover threshold to leave scheme	1,600,000

Flat rate scheme	
Annual taxable turnover limit (excluding VAT) to join scheme	150,000
Annual total income (including VAT) to leave scheme	230,000

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